PACIFIC TRADE AND DEVELOPMENT, II

Papers and Proceedings of a Conference
held by The East-West Center, Honolulu,
in January 1969

Edited by
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PREFACE

The Second Conference on Pacific Trade and Development was held at the East-West Center from 8th through 11th January 1969 both to follow-up the results of the first conference held in Tokyo, January 1968, on the Pacific Free Trade Area scheme and also to discuss the trade and aid relationships of the Asian developing countries with the advanced Pacific countries. Contained in this book are the papers and proceedings of the conference.

International trade and monetary policies in the Post-Kennedy Round world and the Nixon Government era are in a fluid state groping towards a new direction. Also the results of the Second United Nations Conference on Trade and Development last spring point to the conclusion that a new design for expanding trade and for accelerating economic development both within and between advanced Pacific countries and Asian developing countries must be put into practice.

Really, the expansion of trade and the promotion of economic development with closer cooperation in this Pacific and Asian region which has a huge potential should be a critical focus for the world which finds itself in a trade and monetary turmoil. A number of useful proposals to meet these ends were thrashed out in the conference. Several difficulties in realizing them were also envisaged and everyone was well aware that further studies would have to be undertaken.

As indicated in the communique issued by the conference, our study should be continued. Our academic studies, I am confident, will throw light, gradually but steadily, upon pragmatic policies of the governments and business circles concerned.

I am deeply grateful to all the participants and the Hawaii Committee who have worked so hard and who have created a new design for the economic development of the Pacific/Asia region.

Kiyoshi Kojima
Chairman of the Steering Committee
for "Pacific Trade and Development"
Professor, Hitotsubashi University,
Tokyo

COMMUNIQUE

The Second Conference on Pacific Trade and Development was held at the East-West Center, from 8-11th January 1969 to discuss alternative trade policies for advanced Pacific countries, the aid and trade needs of less developed countries, and the scope for increased economic cooperation within the Asian-Pacific region. Sponsored by the State of Hawaii, the Japan Economic Research Center, the United States' Agency for International Development, the Asia Foundation, the Australian National University and the Standard Oil Company of California with support from the East-West Center, the Conference developed the theme of discussion at the first Conference held in Tokyo last January. Economists from Australia, Canada, Indonesia, Japan, New Zealand, the Philippines, Republic of Korea, Republic of China, the United Kingdom, and the United States participated in the Conference.

Governor John A. Burns addressed the opening of the Conference. He emphasized the role of the Conference in broadening the dialogue on questions relating to the establishment of a Pacific Community of Nations.

Discussion ranged over a large number of important trade and aid issues. These included the limited success of the Second United Nations Conference on Trade and Development in dealing with the major issues in the economic development problem. The Conference stressed the importance of providing freer access for exports from less developed countries to advanced country markets. Special studies of trade and development in Taiwan and Korea highlighted these issues. But the Conference also recognized the fact that not all less developed countries could benefit substantially in the near future from trade concessions alone. This was clearly evident in a study of the Indonesian development problem. Considerable emphasis was therefore given to the importance of increased aid effort designed to improve agricultural productivity, promote new industrial development, and provide the infrastructure necessary to a successful development program.

The Conference also discussed proposals for a Pacific Free Trade Area in the context of possible changes in world trade policies. It recognized the gains from a free trade area. But it also recognized that there are difficulties which prevent the adoption of any such proposal in the near future. Alternative policies for closer economic integration in the Asian-Pacific region were considered. In particular, the Conference examined the possibilities for promoting closer economic cooperation among Japan, Australia, and New Zealand, short of the formation of a comprehensive free trade area.

Any trade arrangement among advanced Pacific countries should be coupled with more extensive trade concessions for exports from less developed countries and more cooperation in aid-giving. It was suggested that the establishment of an Organization for Pacific Trade, Aid and Development might effectively promote these objectives.

The Conference also considered the prospect for international monetary cooperation within the ECAFE region, particularly proposals for a clearing and/or reserve union among ECAFE countries. Further study of such arrangements appeared especially urgent in view of the constraint that continued international monetary crises might put upon regional development aims.

Participants at the Conference stressed the need in their countries both for continued public discussion of these important problems and for their regular consideration by governments. They will confer on arrangements for a further conference to discuss some of the more specific issues that were raised.

January 11, 1969

Honolulu, Hawaii

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Part I

FUTURE WORLD TRADE POLICY

Chapter 1

THE NORTH-SOUTH PROBLEM IN THE WORLD ECONOMY AND THE IMPLICATIONS OF UNCTAD 1968

Harry G. JOHNSON

"The North-South problem in the World Economy" is a term convenient for distinguishing the problem of economic relations between the developed and the developing countries from the problem of international relations between the centrally-planned and the free-market economies--the so-called "East-West Problem." Neither description is of course geographically accurate, as the presence of Australia and New Zealand among the developed countries and of Japan as a country traditionally regarded as "Eastern", but now also an industrially advanced and predominantly market-oriented economy, testifys. But the terminology is sufficiently defensible to serve its purpose.

More concretely, the North-South problem derives from the wide gap between the average incomes of the developed industrialized nations and the poor nations anxious for development, and also between their normal rates of economic growth, especially of growth in per capita incomes. This latter gap is aggravating the existing disparities of living standards between the two groups of countries. The problem is to narrow the gaps by the adoption of appropriate policies by the developed countries, designed to accelerate the development of the less developed and poorer nations. Recognition of and concern about this problem on the part of the developed nations has always been the outcome of a mixture of motivations--humanitarian concern about the relief of poverty, economic concern about the development of markets for exports and about securing favourable treatment of foreign investments by nationals, and, particularly at the outset, politico-military concern about the attraction and adhesion of allies in the cold war and the establishment of economic conditions conducive to political stability in the poorer nations. These motivations do not necessarily lead to the same kind of economic policies for promoting economic development. On the contrary, some of them have led to policies contrary to that end, at least in the judgment of some experts-- for example the preservation of ruling oligarchies and the support of substantial military capabilities by lavish economic assistance.

Confusion about the objectives of economic assistance of various kinds generally lumped together as "development assistance" is in fact largely responsible for the current state of wide-spread disillusionment in the developed countries about the effectiveness and usefulness of development assistance. A contributory factor to this disillusionment was the initial illusion on the part of the United States that the development problem could be solved in the same way as the problem of European economic recovery, by modest pump-priming with American capital and technical assistance over a short period of economies that otherwise possessed the prerequisites of industrial competence. In fact, the poor countries were and are poor in all senses, not just that of shortage of capital to co-operate with the other factors of production, and much capital was wasted in the process of learning that development requires much more than an addition to the stock of capital equipment and will take a much longer and more sustained effect than the Marshall Plan.

In addition to the disillusionment with development assistance just mentioned, other more objective tendencies in the world economy have been operating to attenuate the concern of the developed countries with the poor countries and to reduce their willingness to provide such assistance. Politically, the attainment of a *modus vivendi* between the United States and the Soviet Union, signalized notably by the outcome of the Cuban crisis of 1962, has greatly reduced the pressure to compete for political allies by generosity of assistance-- a competition which in any case was proving itself to be self-defeating. Militarily, the development of new technologies of offense and defense has greatly reduced the dependence of the major powers on far-flung strategic bases, and therefore the need both to spend on the maintenance of these bases and to purchase political acceptance of them. On the economic side, two of the major aid donors, the United States and the United Kingdom, have been in chronic balance-of-payments deficit, and hence under mouting pressure to reduce their foreign aid contributions, while--as a consequence of the growing malaise of the international monetary system--surplus countries have been reluctant to increase their aid donations unilaterally for fear of the balance-of-payments consequences. Finally, on the side of humanitarian concern for the relief of poverty, that concern has in the United States been shifted by domestic disorders from the relief of foreign poverty to the relief of domestic poverty and the provision of greater opportunities for the minority to share in the general affluence. Other developed countries have in various way been subjected to mounting internal pressures and discontents, which can only be relieved by substantial increases in public expenditure. Hence these problems lower the political priority of assistance to the economic development of the poor countries.

In short, the motives for concern in the North about accelerating development in the South have been gradually whittled down by the general trend of international economic and political relations to the primarily humanitarian; and the humanitarian motive has been increasingly preoccupied with pressing domestic problems of poverty amid affluence. In these circumstances there is a need for a reaffirmation of the moral commitment of the developed countries to help promote the development of the poor countries, a reaffirmation which presumably Mr. MacNamara is seeking through his recent appointment of Mr. Lester B. Pearson to chair a prestigious Commission on International Development, to conduct a "grand assize" into the whole question of economic development policy. There is also a need to explore new policy techniques that might be employed by the developed countries to foster the growth of the poor nations, and the arguments for so employing them.

The prospective inadequacy of foreign aid to cover the net foreign exchange requirements of the development plans of the less developed countries became increasingly apparent towards the end of the 1950's, and naturally directed attention towards the alternative of expanding opportunities for earning foreign exchange by means of exports, and also towards ways of increasing the real contribution of existing aid flows. In addition to the foreign exchange motivation of interest in expanding export opportunities, the experience of some of the more industrialized developing countries with industrialization based on protection in the domestic market ("inward-looking industrialization") had convinced their experts that such industrialization was highly inefficient and prone to be self-limiting if not self-defeating, and that what was required was access to larger, foreign, markets, both in the advanced countries and among the other developing countries. Moreover, experience of attempting to develop exports of their manufactures had disclosed the existence of substantial barriers placed in their way by the trade policies of the developed countries. Finally, there were long-standing grievances over the prices and the price-instability of the primary products that formed the mainstay of their exports--characteristics of the trade in these products partly attributable to the agricultural protectionist policies of the advanced industrial countries.

This was the background of the first United Nations Conference on Trade and Development, held in Geneva from March to June 1964.

In the background document for that Conference,[1] its Secretary-General, Dr. Raúl Prebisch, presented a powerful argument for a new trade strategy for development, based on an appeal for equity and parity of treatment of producers in less developed countries in competition with those in developed countries. Specifically, he called for international commodity agreements to give less developed producers of primary products the same sort of price-support and price-stabilization assistance as were enjoyed by the farmers of the developed countries; for preferential access for exports of manufactures and semi-manufactures from developing countries to the markets of the developed countries, to enable them to compete on equal terms with the manufacturers of those countries, their preferential advantage over other advanced-country manufacturers in that market compensating for the competitive disadvantages of under-development; and for preferential arrangements among developing countries, falling short of the free internal trade arrangements which are the only exception allowed to the GATT rule of non-discrimination, to permit them to gain the advantages of specialization in a larger market.

As I have argued in my study of the issues raised at the 1964 UNCTAD,[2] the developing countries had valid and weighty grounds for complaining that the trade policies of the developed countries, and the system of regulating international trade within the framework of GATT, were biased against their exporting interests. These included the *de facto* exemption from GATT of domestic price support schemes for agricultural products, implemented by quotas, which both narrowed export markets and accentuated the instability of prices; the tariff bargaining procedure of GATT, which until the Kennedy Round concentrated the reductions of tariffs to manufactures of prime interest to the large developed countries (and even in the Kennedy Round retained vestiges of such concentration through the exemptions lists); the typical escalation of tariff rates in national tariff structures by stage of production, which discriminated in favour of imports of raw materials and

1. Raúl Prebisch, *Towards A New Trade Policy for Development* (United Nations, 1964).

2 Harry G. Johnson, *Economic Policies Toward Less Developed Countries* (Washington, D.C.: The Brookings Institution, 1967); see also idem, The World Economy at the Crossroads (Oxford: The Clarendon Press, 1965), Chapter 5.

against imports of manufactures, and hence impeded the industrialization of the developing countries; and the application within GATT of quota restrictions on the exports of cotton textiles from the less developed countries. A further point, to which I should have given more attention in my study, was that the formation of the European Economic Community and subsequently of the European Free Trade Association greatly extended the market area of protection of manufacturers in developed countries from their competitors in the developing countries, by giving members of these arrangements free entry to the mrkets of other members.[3]

While the developing countries had cogent grounds for complaint against the existing system of national and international economic policies, and for demanding sweeping changes in that system designed to improve its equity and promote their own economic development, the changes they demanded, or at least the two most important of them (commodity agreements and manufacturing preferences), were in my judgment poorly considered, for a variety of reasons. First, the ideal solution in principle would be to eliminate the discriminatory protectionist barriers to free international trade, and to seek to promote world economic development on a basis of dynamic comparative advantage;[4] the inversion of existing protectionism in favour of the producers of the developing countries is economically a second or third best solution to the problem. Second, the very political forces which generate and maintain protectionism in the advanced countries are likely either to resist strongly the resulting exposure of domestic producers to competition from the developing countries, or to accept it only in return for safeguards which might actually worsen the market op-

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3 It is true that some developing countries--the Associated Overseas Territories of the Common Market--also obtained this preferential entry, without having to reciprocate. But the effect was to accentuate the discriminatory effect against other developing countries not included in the Associated Overseas Territories.

4 By this is meant the gradual transfer of production from advanced to less developed countries in response to wage differentials and the gradual standardization of new technologies of production. For a fuller statement of a dynamic theory of comparative advantage, see my Wicksell Lectures, Comparative Cost and Commercial Policy Theory For a Developing World Economy (Stockholm: Almqvist and Wiksell, 1968)

portunities of the developing countries in the longer run. Third, a great deal of prewar and postwar experience with international commodity agreements has shown them to be extremely difficult to negotiate and to operate. Moreover, the probable effect of preferences on the exports of the developing countries is an empirically unknown quantity, while theory indicates that the net real resources for development contributed by additional exports could only be a fraction of the increase in the quantum of exports itself. Thus there are strong reasons in both cases for doubting whether the contribution to foreign exchange earnings and to development resources that would result would justify the complex changes in trade policy that would be required to bring them about.

Be that as it may, the 1964 UNCTAD was a substantial success in calling the manifold grievances of the developing countries in the field of international trade policy, and to a lesser extent aid policy, forcibly to the attention of the developed countries. Most notably, from the standpoint of the basic principles for the conduct of international trade and trade policy, the United States, which at Geneva had stood firm on the principle of non-discrimination in opposition to the demands of the developing countries for trade preferences, reversed its stand in April 1967 and subsequently co-operated with the other members of the Organisation for Economic Co-operation and Development in preparing an agreed set of principles for a preference scheme in manufactures for presentation at the 1968 UNCTAD. More recently, GATT has agreed to the establishment of partial preference schemes among developing countries.

The second UNCTAD was originally projected to be held in 1966, but was delayed until March 1968 by organizational difficulties, both in setting up and staffing the institution itself and in preparing for the Conference. This delay was extremely unfortunate, from the point of view of the interests of the South, because during the interim occurred the events mentioned above as sapping the commitment of the developed countries to the assistance of the developing countries--the rapid worsening of the United States balance-of-payments position, the deterioration of the British position culminating in the devaluation of 1967 (a particularly serious blow since in the 1964 Conference Britain had exerted considerable moral leadership), an increasingly unstable international monetary situation, and increasing preoccupation of the developed countries with their internal affairs. As a result of these developments, and also of the emergence of conflicts of interest among the developing countries which had been successfully papered over at the 1964 Conference, and the eclipsing of the Conference by the international monetary disturbances of the autumn and winter of 1967-68, which culminated in the gold crisis of March 1968, UNCTAD was a virtually unrelieved failure.

A significant contributory factor to this outcome was the so-called "group system" of arriving at decisions and resolutions at the Conference. A great deal of the success of UNCTAD 1964 as a forum for effective expression of the grievances of the developing countries about the trade and aid policies of the developed countries was due to the fact that the developing countries, under the leadership and inspiration of Dr. Prebisch, had welded themselves into a majority voting bloc, whereas the minority of developed countries arrived at the Conference with diverse positions that reflected their different national situations and approaches to policy and also the divisions among them that had arisen during the preparatory stages of the Kennedy Round negotiations and indeed had their roots in the complex diplomacy of postwar European economic integration. The developed countries were therefore taken by surprise, and the differences among them exploited to the disadvantage of their public images. The developing countries ("the group of 77") sought to repeat this political success--necessary to assert the maximum moral pressure on the developed countries to grant concessions that could not be extracted from them by majority voting along--at the 1968 UNCTAD by drawing up an agreed set of demands (the "Charter of Algiers") at a preparatory meeting in Algiers. But the natural response of the developed countries, after the experience of Geneva, was similarly to group themselves into a bloc ("Group B") and concert their positions in advance. Moreover, given the asymmetrical relationship between the "Group of 77" as demanders and "Group B" as suppliers of concessions, it was equally natural--though highly unconducive to successful negotiation--that the "Group of 77" should tend to achieve unanimity on the basis of the most extravagant demands of some members, and that "Group B" should correspondingly tend to achieve unanimity on the basis of the least generous concessions individual members were prepared to offer. This polarization, and other organizational weaknesses inherent in large Conferences, tended both to encumber or paralyze negotiations, and to divert the proceedings from negotiations to declamations and confrontations.

The central objective of the 1968 UNCTAD, as a sequel to the 1964 UNCTAD, was to contribute to the formulation of a development policy for the second Development Decade "by approving a series of concrete measures to accelerate the rate of economic and social growth of developing countries and by inserting these measures into the basic framework of a broad strategy for development, as encouraged by the General Assembly."[5] The prime emphasis was on the production of an agreed strategy, which the Secretariat had prepared but which it withheld "before it became clear whether fundamental positive results would emerge; and they did not. A global strategy without concrete measures would have been another document of pious declarations without any practical consequences."[6]

The Conference thus failed in its longer-range aim of producing a global development strategy, because it failed in its proximate aim of producing concrete solutions to sufficient important problems of promoting development. For this the group system, and more specifically the insistence of the developing countries so expressed in the Charter of Algiers on the need for special measures for the least developed countries so that all the developing countries would derive comparable gains, was largely responsible --because the way in which the subjects for discussion were divided up ensured that equality of benefit would be impossible to attain. As had become clear from the 1964 UNCTAD, the individual developing countries have widely divergent interests: most obviously, the more developed are interested in exports of manufactures, and the less developed in exports of primary products; in addition, they are divided among those in the Commonwealth Preference System, those associated with the European Common Market, and those excluded from either preferential system. Thus while, as had been cynically remarked of them at the 1964 UNCTAD, it was easy enough for them to agree on the highest common denominator of demands on the developed countries, it was also--as had been predicted by some analysts of the first UNCTAD, and as proved the case at the second UNCTAD--very unlikely that they could find any common interest in practical proposals for trade policy change, and therefore agree to them without extensive wrangling, if at all.

This probability was verified, most surprisingly to the Group B countries, with respect to the proposal for a preference scheme in manufactures and semi-manufactures for the exports of the developing countries. As recorded above, this was the most hotly-

5 Raúl Prebisch, "The Significance of the Second Session of UNCTAD," UNCTAD, TD/96, 7 May, 1968, p.2.

6 Ibid., p.8.

contended proposal to emerge from the 1964 UNCTAD, and one with respect to which the United States reversed its original opposition and co-operated with the other OECO countries in the production of an agreed plan for a general preferences scheme for presentation to the Conference. That plan was a collection of principles and elements rather than a concrete scheme, and it left unresolved the question of abolition of "reverse preferences" (preferences for developed countries in the markets of developing countries under Commonwealth Preferences and Association of Overseas Territories with the European Common Market); but it did represent a major concession of principle, and the developed countries expected it to be warmly welcomed. The welcome was indeed warm, but in a quite contrary sense. Developing members of an existing preference area were worried lest they should lose more by sharing their existing preferences with other developing countries than they would gain from access to the markets of the developed members of the other preference area and the United States. More important, preferences in the manufactured items envisaged for inclusion in the scheme were of interest only to a minority of the developing countries, these with a manufacturing capability. To extend the range of beneficiaries in accordance with the principle of equitable sharing of benefits, the "group of 77" insisted to the last possible minute that the general preferences scheme must include processed and semi-processed agricultural and other primary products from the beginning, in place of these products being dealt with as proposed on a case-by-case basis as the scheme evolved. In consequence, instead of positive adoption of the proposal, a special committee was set up to continue work on the details of the scheme, with the objective of having a definite scheme ready by late 1969. This objective is in all probability too optimistic, though it may be considered a longer-run achievement that some sort of preference scheme is on its way.

With respect to other major areas of discussion, significant positive results failed to emerge for a variety of reasons, involving both the unwieldiness of the group system, the balance-of-payments difficulties of the United Kingdom and the United States, and fundamental economic problems. The work on commodities schemes advanced little beyond the recommendation that existing efforts to negotiate such schemes on certain eligible commodites, and a variety of research programmes, should be continued. Nothing was accomplished with respect to improved access of developing country exports of primary products to the markets of developed countries. The proposal prepared by the World Bank for a supplementary financing scheme to enable countries suffering shortfalls in export earnings below projected levels to continue their development plans was sent back for further study, because the countries that would have had to supply the required resources were unwilling to do so for balance-of-payments reasons.

The only potentially significant concession from the developed countries to the developing (the general preferences proposal apart) was in the field of finance, where it was agreed to change the denominator used in applying the "one per cent of national income" principle for financial resource transfers from the former to the latter from net national income at factor cost to gross national product at market prices. This would raise the required aid volume by about 25 per cent of existing levels. The value of this concession, however, remains problematical owing to the unwillingness of most developed countries to specify a target date by which the change would be implemented. As the international monetary situation and the positions of the United Kingdom and the United States have been evolving over the past three years, it appears extremely unlikely that present aid levels will be maintained, let alone the new targets be implemented.

The 1968 UNCTAD was therefore a virtually unqualified failure. Of its two noteworthy positive accomplishments, the increase in targeted aid levels is a very doubtful promise rather than a firm commitment, while the general preferences proposal remains to be worked out in detail and its outlines themselves are rather nebulous. Moreover, with the increase in international monetary uncertainty that commenced before the date of UNCTAD 1968 and has heightened appreciably since then, work on the proposal may be indefinitely suspended, or else what emerges may turn out to be a protectionist and trade-restrictive scheme rather than the hope for opening out of large export opportunities in manufactured goods for the developing countries.

The failure of UNCTAD 1968 raises two important questions. The first is whether UNCTAD in its present form has ceased to serve a useful purpose. UNCTAD 1964 caught the developed countries by surprise, and enabled the developing countries to dramatize their grievances sufficiently to change the thinking and approach of the developed countries, notably on the issue of trade preferences (including preferences among the developing countries). But the developed countries learned from the experience, and at UNCTAD 1968 were able to let the divisions of interest among the developing countries themselves prevent much of importance from happening, and at the same time to shed some of the burden of responsibility for the ills of the developing countries that had been heaped upon them at UNCTAD 1964. It therefore seems that the process of confrontation of the two groups at time-consuming monster meetings has lost its moral shock power, and that its expense, inefficiency, and irrelevance to the solution of concrete issues are no longer justified by its possibilities of making progress. On the other hand, it is clear that understanding of the real issues has been furthered by the research that has been stimulated and carried out, both inside and outside the UNCTAD organization, as a result of the 1964 confrontation. Perhaps UNCTAD would be well advised to eschew monster international rallies in future, and to emphasize research and discussion by small expert groups, in co-operation with other established international institutions.

The second and more important question is how, if at all, efforts to promote the economic development of the South by increases in development assistance can be intensified, given that the UNCTAD route has probably reached its limits, and may even have passed them, in the sense that the failure of UNCTAD 1968 may give the developed countries the feeling that they have done everything reasonable for the developing countries.

As mentioned earlier, there is an obvious need for a renewal of the moral commitment of the developed countries to help the developing, a commitment that was long accepted without much thought as requiring only contributions of development assitance, and which was gradually withering under the pressures of changing circumstances. This commitment was stirred up again by the challenge of UNCTAD 1964, and is in all probability subsiding again. It seems unlikely that the efforts to renew the commitment now being mounted by religious, intellectual and social leaders, and by the institutions of the United Nations, notably the World Bank, will be very effective in persuading the political leaders and governments of the major industrial countries collectively to become suddenly more generous in their aid and trade policies towards the developing nations as a group.

That being so, there would seem to be several avenues worth exploring. One, of course, would be for individual smaller advanced nations feeling the obligation to assist the poor nations particularly strongly to press ahead on their own rather than wait for the large nations to set a more generous example for them to follow. This has been happening to some extent, for example in the case of Canada. Another would be for governments to provide more incentives or opportunity for individuals to make contributions to the growth of the developing nations. Tax incentives for private corporations to invest in such countries have frequently been suggested, and might become a major instrument of U.S. development assistance policy as official foreign aid is whittled away by Congress. But something substantial might be accomplished also to encourage donations of cash by individual citizens, for example by making such donations deductible from income for tax purposes, or even going further and making them directly deductible from taxes due. (This would amount to letting private citizens rather than government determine how much of their taxes should be allocated to the purposes of development assistance.)

Another alternative, which is in line with the theme of this Conference, would be for the advanced nations to assume special responsibility for development assistance to developing nations with which they have special historical or geographical links. This has been a major factor in French and British development assistance in the past. The chief drawback of this approach is that, as it operates between single large nations and groups of small countries, it tends to create dependency and facilitate political and economic exploitation. For this reason, an arrangement between a grouping of advanced nations and a fairly numerous group of developing nations would be superior. Group co-operation of the advanced to promote the development of the less developed, however, would probably have little impetus unless such co-operation were also providing fairly direct benefits for the co-operating advanced nations. Thus the notion of linking co-operation in promoting development with co-operation in the liberalization of trade among the advanced nations and between them and the less developed nations makes political and economic sense. This notion is incorporated in both the NAFTA and the PAFTA proposals, and the proposal for a Multilateral Free Trade Association that would embrace them both.[7]

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7 For more detailed argument on this point, see David Wall, The Third World Challenge, (London: The Atlantic Trade Study, 1967).

COMMENTS ON HARRY JOHNSON'S PAPER BY HIROSHI KITAMURA

Professor Johnson's paper reflects the sense of crisis that prevailed over the North-South problem after the failure of UNCTAD II. I am not quite sure whether UNCTAD II was the virtually unqualified failure," Professor Johnson appears to believe it was.

Let me first put Professor Johnson's conclusions into the perspective chosen by the author. Although he recognizes the need for linking development assistance with trade liberalization, the impression is that his hopes for solutions to the North-South problem hinge on economic aid rather than on trade policies. If this correctly describes Professor Johnson's position, we seem to have experienced a complete circle in the change of views over the course of the past 20 years, whereby policy deliberations at international forums appear to have followed the academic discussions of economists with a certain time lag. After the war, development aid became an integral part of the world economic policy, mainly because changes in trade policy involving far-reaching adjustments in the structure of production met with greater resistance in the industrially advanced countries; aid was conceived of as a convenient substitute for trade concessions. Towards the end of the 1950's, economists' thinking was increasingly directed to the position formulated in terms of "Not aid, but trade," or "Not aid alone, but aid and trade." When the attempts of the two UNCTAD conferences to tackle the problems of trade adjustment frontally failed to produce immediate results, the swing has now turned back again towards emphasising aid. Should we expect, then, that forthcoming international deliberations will mainly revolve around the questions of aid, avoiding the more difficult problems of trade adjustment?

It is, indeed, within the framework of the second United Nations Development Decade that what Dr. Prebisch termed "a global development strategy" will be formulated. UNCTAD II may have failed to produce "concrete solutions to the important problems of promoting development" (p.10), but, as Professor Johnson is well aware, to produce a broad strategy for development was beyond the confine of UNCTAD's original assignments. It was obvious that development, being a multi-dimensional problem, cannot be approached effectively from the trade angle alone. What we could now legitimately say is at least that the international deliberations of the past were not sufficiently focussed on the core of the development problem. We cannot expect a global development strategy to be formulated without a comprehensive attach on the world development problem, and it would be difficult to have the mutual committments of both of the developed and the developing nations to the cause of world development effectively established without such a strategy.

This is precisely what the "Development Charter," as proposed by the Government of the Netherlands, or the concept of a Development Decade is aimed at. The elements of such a global strategy will be a set of targets covering all the major determinants of development, with specification of the policies and measures conducive to the realization of these targets. Adequate stress will have to be given to the acceptance by the developing countries of the basic discipline of development efforts, including full mobilization of domestic resources, material and human. Equally important will be clear commitments on the part of the developed countries to facilitate the establishment of favourable trade conditions, along with the timely and continuous inflow of adequate development assistance. Now, a new idea of great importance has been introduced into the international discussion to give more effect to the moral commitments for development: the global strategy will not be merely a plan of action, but a continuing function with machinery for "international surveillance." If accepted by majority vote in the General Assembly, this may mean that the world community moves one step forwards in establishing an implementing authority for what Professor Tinbergen calls "international economic policy." Thus, the North-South problem may be brought closer to solution. While recognizing many difficulties lying ahead, I would be inclined to be a little more hopeful about the prospect of joint commitments for world development than Professor Johnson appears to be.

With regard to the analysis of the background which gave birth to UNCTAD, I am largely in agreement with Professor Johnson. He writes: "the developing countries had valid and weighty grounds for complaining that the trade policies of the developed countries, and the system of regulating international trade within the framework of GATT, were biased against their exporting interests." (p.6) But, if the GATT system of multilateral free trade, based on the principles of nondiscrimination and reciprocity, was biased against the development needs of the poor nations, that is, if conditions for "the ideal solution" (p.7) of free trade were not fulfilled, a partial approach towards freer trade would not necessarily represent a second-best solution. In these circumstances, "the inversion of existing protectionism in favour of the producers of the developing countries" (p.7) should not be rejected as "economically a second or third best solution to the problem." (p.7) It stands to reason that, if there is built-in discrimination against the developing countries' trade position, it must be offset by deliberate discrimination of the opposite sign. This is the basic justification for the general preferences scheme for exports from the developing countries. Such a scheme should legitimately include processed and semi-processed primary products from the beginning, as the processing of primary products is an inevitable phase of industrialization.

UNCTAD II amply demonstrated how inefficient world-wide negotiations can be in reaching agreement on the rights and obligations of all nations in detail. But, Professor Johnson's well-intentioned advice that UNCTAD should "emphasize research and discussion (p.14) in the future is likely to meet with strong objections on the part of the developing countries. It was after all the demand for active decision-making that brought UNCTAD into existence.

Assuming that joint responsibility of the world community for development is unlikely to be established in the form of moral or legal commitments, Professor Johnson suggests that a group of advanced nations may "assume special responsibility for development assistance to developing nations with which they have special historical and geographical links." (p.14) The implicit assumption is that a system of group co-operation would be efficient enough to avoid the danger of dependence and exploitation. In so far as present bilateral aid relations can be multilateralized, the proposal deserves favourable consideration. The idea is also in line with the growing importance of economic regionalism. In designing such a development strategy at the level of regional or other groupings, however, it is important to maintain the general principles of a global strategy as closely as possible. Commitments and joint surveillance may be organized more intensively at the regional level than at the world-wide level. But, "special responsibility" will primarily apply to the provision of development assistance. In the field of trade cooperation, the preferences should be provided on the basis of non-reciprocity so as to avoid so called "reverse preferences"; it is highly desirable that the special preferences given to a particular group of developing countries are generalized to other developing countries in the course of time. The creation of exclusive "spheres of interest" on the basis of special historical or geographical links should not be part of such a strategy.

Chapter 2

THE FUTURE SHAPE OF U.S. TRADE POLICY: MULTILATERAL OR FREE TRADE APPROACHES?

Sperry LEA

INTRODUCTION

The assignment for this paper was to offer a view of the probable "future directions of U.S. trade policy" over a five-year period. Special emphasis was to be given to one particular question: whether, and if so when, the United States might shift its approach to moving ahead from that of multilateral negotiations in the GATT to that of developing some form of free trade arrangement with other countries willing and able to join.

With no information on Nixonian trade policy thinking, nor even as to who will be charged with directing that thinking, the paper was forced to speculate. (Accordingly, the word "directions" in its assigned title was shifted to "shape," as being more descriptive of what one sees in a crystal ball.)

This speculation centers on two aspects of the future:

Section I deals broadly with the immediate, attempting to describe the environment in which Nixonian trade policy will be formulated.

Section II concentrates on but one of the many considerations that will arise during this gestation period: the "if and when" question of a possible shift of U.S. trade policy from its traditional approach to participation in a free trade arrangement.

I. THE GESTATION PERIOD OF FUTURE U.S. TRADE POLICY

We should not expect the outlines of a new U.S. trade policy to emerge from President Nixon's inaugural speech, just eleven days from now. Nor will we see even the tip of an iceberg, for the simple reason that the iceberg itself is far from being crystallized.

What January 20, 1969, will mark is the start of a year of gestation on trade policy roughly comparable to that which began when President Kennedy took office just eight years ago. Some aspects of the formative process may occur in public view through the operations of hearings or commissions. The Johnson Administration's broad trade policy study (the Roth Report) should be released soon, though its influence on the new Administration's assessment is problematical.[1] But, in any event, it is unlikely that we shall know the full design and rationale of a Nixonian trade policy initiative before this time next year, when it may be unveiled in the President's Second State of the Union Message.

1969 vs. 1961

In seeking clues as to what may emerge a year from now, we have amazingly little to go on. The President-elect has set up no special task forces on trade policy, nor has he announced his new Special Representative for Trade Policy to follow Ambassador Roth. We are embarking on a certain odyssey without, as yet, Odysseus.

Perhaps we can gain some insight by noting in what ways the present situation differs from that of eight years ago, when trade policy was last reassessed by a new Administration. There appear to be at least three areas of basic contrast between 1961 and 1969.

A. First of all, the gestation of U.S. trade policy during 1961 was relatively free to concentrate on a single task of determining how best to move ahead. In 1969, however, such forward thinking stands to be severely distracted by several threats to past accomplishment, each claiming immediate attention:

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1 In March 1967 the President directed the Special Representative for Trade Negotiations (Ambassador Roth) to conduct a comprehensive study of future U.S. foreign trade policy and to recommend such legislative and other measures as might be required. Public hearings were held during the spring of 1968 and a final report has been prepared with the participation of a public advisory Committee. The topic, "Participation in free trade areas" was one of six listed at the outset under the heading of "Future Trade Negotiations." (The Roth Report was released on January 14, 1969, a few days after this paper was presented.)

1. For the first time in 75 years, the U.S. trade surplus threatened, in 1968, to disappear. (It ended up at an estimated + 0.5 $billion.) An immediate task for trade policy planners will be to raise the trade surplus from this level to the more usual $4 - $5 billion. To be actively considered are a variety of stimulants to exports and more determined efforts to neutralize the subsidies given to some foreign exports in violation of U.S. law. Perhaps the most effective way to improve the trade balance under present circumstances is to moderate inflationary growth by fiscal and monetary action plus, hopefully, to curtail Vietnam expenditures. This means that trade policy strategy, at least in the short run, will be closely coordinated with domestic economic decision-making at the highest levels.

Such preoccupations did not intrude on trade policy planning to any comparable degree eight years ago, following a trade surplus of $4.8 billion in 1960.

2. Protectionist pressures offer another threat that is greater in 1969 than in 1961. Since the end of the Kennedy Round, a wide range of U.S. domestic industries, sometimes joined by associated trade unions, believe themselves threatened by increasing imports. The remedy usually advocated has been quotas which would limit the growth of import penetration to some "fair share" of the U.S. market. The extent of quota proposals and their Congressional sponsorship has been imposing, as the following table shows.

As a result of strong counter-pressures, none of these proposals were passed by the Congress during 1968, and had they been, it is unlikely that the President would have signed them into law. Nevertheless, the prospects are for a renewed campaign in 1969, probably concentrating on a few key products -- man-made textiles is a leading candidate -- and justifying itself more than last year on balance-of-payments grounds. The first occasion for the new Administration to show its hand on trade policy will probably come when it responds to the 1969 crop of quota bills.[3]

3 Johnson Administration officials have recently outlined a four-point program to deal with the protectionist drive: (1) making it easier for firms and workers under competitive pressure from imports to get adjustment assistance; (2) equivalently liberalizing escape clause rules to permitting recourse to protection,

Estimated Coverage of U.S. Quota Proposals[2]
(as of early 1968)

Particular products for which bills have been introduced to apply quotas where none existed, or to make existing quotas more restrictive.

Product	Co-Sponsoring Senators [a]	Separate House Bills	U.S. Imports, 1966 ($ millions) Total	From Major Suppliers
Petroleum & products, excl. resid. fuel oil	29	46	$1,434	Venezuela $504; Canada $332; Middle East $218
Steel & pig iron, excl. ferroalloys [b]	36	66	1,253[c]	Japan 565; EEC 447
Textiles	68	200	1,100	Japan 410[d]
Residual fuel oil	--	2	738	Venezuela 381; Netherlands Antilles 199
Meat, meat products	38	71	598	Australia 178; EFTA 91; New Zealand 61; Canada 49
Consumer electronic products & components	11	--	565[e]	Japan 354; EFTA 53; EEC 47; H. Kong 43; Canada 25
Lead & zinc	28	34	228	Canada 86; Mexico 22
Footwear	9	4	190[f]	EEC 86; Japan 49; EFTA 30
Hardwood plywood	--	1	150	Japan 55; Korea 25; Taiwan 22; Philippines 22
Groundfish	8	7	125	Canada 76; Iceland 14; EFTA 11; Japan 10
Mink skins	2	58	73	EFTA 47; Canada 12
Ferroalloys	1	1	71	EEC 19; South Africa 15; EFTA 14
Dairy products	59	190	65	EEC 25; EFTA 20
Potash	2	1	61	Canada 52; EEC 8
Flat glass	6	3	56	EEC 33; Japan 11; EFTA 6
Roller, ball bearings	3	--	52	Japan 26; EFTA 11; EEC 9; Canada 6
Strawberries	8	11	16	Mexico 15
Stainless steel flatware	1	7	11	Japan 8; EEC 1
Scissors & shears	1	--	5	EEC 5
Honey	5	15	1	Mexico 1
Total		717	$6,792[g]	

[a] From the Senate bills as reprinted in Import Quotas Legislation, Hearings before the Senate Committee on Finance, 90th Congress, First Session (October 1967), 1218 pages. [b] A House bill included iron ore and excluded Canadian products. [c] Figures for individual countries are estimated by applying their share of total tonnage to value of total imports. [d] The Japanese textile figure is taken from the quota Hearings, p. 903. Data for other major supplying countries have not been compiled. [e] Figures for individual countries cover radios, television sets, and phonographs only. [f] Figures for individual countries cover leather footwear only. [g] The $6.8 billion = 26% of all U.S. imports and 42% of all dutiable imports in 1966.

2 This chart, published in Looking Ahead, National Planning Association, February 1968, was derived from Constructive Alternatives to Proposals for U.S. Import Quotas, a Statement of the Canadian-American Committee of the National Planning Association (U.S.A.) and the Private Planning Association of Canada, February, 1968. The coverage given represents an estimated 55% of Australian and 43% of Japanese exports on the United States in 1966.

3. The accomplishments of past trade agreements are also threatened by the national practice -- not present in 1961 -- of manipulating trade barriers as a means of dealing with balance-of-payments crises and/or defending currencies against devaluation (or, in the case of Germany, revaluation). This situation calls for an internal decision by the new Administration on whether to join this trend, for instance by adopting U.S. border taxes. At some point there may also have to be international attention to a fundamental question: Is it to be the destiny of the world trading system to become the international adjustment mechanism of first recourse so that other international economic rules can remain undisturbed in times of crisis?

4. The GATT now faces challenges to its letter and spirit far graver than any that existed in 1961. These come from all its weightiest members. European countries are now proposing a partial free trade link among EEC and EFTA countries that clearly violates GATT rules; so do Japanese quotas retained past their justification on balance-of-payments grounds. Strictly speaking, the import tariff surcharges temporarily applied by Canada, the U.K., and France (and considered by the United States a year ago) violate GATT rules for emergency action for balance-of-payments reasons. Other practices, while technically legal under the GATT, are widely considered to challenge its purposes. Examples include the increase in European border tax adjustments, and the retention of U.S. agricultural restrictions (the latter practice having been legalized through a waiver). All this forecasts for 1969 more attention to conflicts between national practice and GATT rules than was necessary eight years ago.

(3 cont'd) but only provided such emergency action would be temporary and for highly selected products; (3) persuading the major foreign suppliers of a particular commodity to exercise voluntary restraint; and (4) making it clear that if any U.S. quotas are applied, equivalent compensation will have to be granted to the injured country and that if such a quota was retained, some mechanism would have to be considered for varying it in relation to domestic price movements. (See Address by the Honorable Anthony M. Solomon, Assistant Secretary of State for Economic Affairs, to the World Affairs Council of Northern California, November 12, 1968.)

B. Secondly, to the extent that Nixonian trade policy thinking will still find itself free to focus on moving ahead, several factors make the forward vista more confused and obscured today than it was at this point eight years ago.

1. In early 1961, the traditional overall goals and appraoch -- namely, further trade liberalization using multilateral negotiatiins in the GATT -- appeared adequate for the next push. (What were considered inappropriate, and thus changed accordingly, were the small scope for U.S. tariff cuts, the item-by-item technique of negotiating, etc.) But in 1969, the traditional goal and approach are both of questionable relevance. The old words have new meanings, often ones that signal new pressures and tasks more serious than those that confronted Kennedy's planners.

2. Take the phrase "International Trade." Purely domestic U.S. producers are now more likely to see in international trade the threat of foreign competition than the opportunities to serve foreign markets. A number of trade unions are having a similar shift in view. An indication is the array of quota proposals listed above. By contrast, the growing number of multinational corporations takes a more positive view of international trade. For trade is essential to the operations of such a firm, enabling a complex choreography of global shipments both of finished products and of inputs that include components and subassemblies as well as raw materials. Such operations have created an associated interest in freer international movement of non-material inputs of capital and management skills.

These broader and conflicting meanings of "International Trade" for domestic U.S. producers and trade unions on one hand, and multinational corporations on the other, promise to make for a wider diversity of pressures in 1969 than in 1961 on the issue of whether the United States should "move ahead" at all. We should also expect more interest than before in making some link between international trade policy and international investment policy.

3. Then, as we all know, the principal meaning of "Trade Barriers" has shifted from tariffs and, to some extent, quotas, to what are usually called non-tariff barriers of NTBs. ("Non-tariff distortions of competition" or "non-tariff measures" are really better terms since we are talking about not merely techniques of restricting imports, but ways of artificially stimulating the production and export of domestic goods to enable them to meet foreign competition at home and abroad.)

It is the new meaning of "Trade Barriers" that raises the most important new problem that must be surmounted if the United States is to be able to move ahead. The shift in emphasis from tariffs and quotas to non-tariff measures means a corresponding shift out of the traditional domain of trade regulations into that of domestic legislation and private practice. This raises serious Constitutional and political questions. Does the President have the authority to offer concessions on other than normal U.S. trade barriers? And even if -- as the present Administration maintains -- he does have this authority, would such a U.S. concession be ratified by the Congress when taken to it? We must keep in mind Senate Resolution 100 of 1966 expressly opposing this procedure, and the present Congressional disinclination for the United States to make concessions on its own non-tariff barriers.[4] As matters stand, we cannot see the way clear for the United States to enter meaningful international negotiations on what the phrase "Trade Barriers" has now come to mean. Undoubtedly a breakthrough will eventually occur, probably in the form of an understanding that the Administration can negotiate U.S. concessions on non-tariff matters on an ad referendum basis, that is, subject to later Congressional ratification. But reaching such an understanding looms as a political task greater than any comparable one faced in 1961.

4. In 1961 the idea of "U.S. Participation in Free Trade Areas," indeed any alternative to the traditional multilateral approach, was unthinkable. Now this topic, phrased as just quoted, is among those considered by the Roth Report for the Johnson Administration. And, as discussed below, forward planning in 1969 will probably devote some effort to comparing both approaches.

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4 Senate Concurrent Resolution #100 was passed by the Senate (but not by the House) in 1966, stating that was the sense of the Congress that the President should negotiate no agreement in the Kennedy Round outside the authority granted by the Trade Expansion Act. It was meant to foreclose U.S. offers to make concessions on its own non-tariff measures. Notwithstanding this, both the American Selling Price Agreement and the International Anti-Dumping Code were negotiated. Partly animating the Resolution was Congressional pique at having been presented by the Administration the Canadian-U.S. Automotive Agreement of 1965 as a fait accompli, in violation of Congressional prerogatives on setting trade policy as this body understands them.

5. The forward vista now lacks the sense of an epic historic movement, such as that of the Grand Design for the Atlantic nations which animated forward trade policy planning in 1961. Nor has there surfaced, as yet, a person corresponding to George Ball, who eight years ago gave a strong and coherent sense of purpose and direction to that year of gestation.

C. Finally, we may question whether the formulation and enactment of a new U.S. trade policy initiative will have the priority in 1969 that it had in 1961.

The supply of forensic energy available in any U.S. Administration to argue new policy into fact is large, but it is finite. Generally it will not be expended equally over what matters much, but focused on what matters most. And nowadays, what matters most is that issue possessing the greatest predicament content. Among international economic questions, monetary and balance-of-payments issues appear clearly to outrank new trade policy initiatives on this score.[5]

This is not to suggest that a new U.S. foreign trade policy will not receive official attention during 1969. But, given greater concern over other issues, plus the need to resolve the political problems with the Congress before the United States can see its way clear to negotiating non-tariff matters, it is conceivable that a new trade initiative would not be ready for announcement in a year's time. Or, if so, it might not be given to the Congress as "must legislation," as was the Trade Expansion Act at the beginning of 1962.

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5 Let us not forget, also, that Kennedy's trade bill was presented with a clear sense of predicament. The first paragraph of its announcement in his Second State of the Union Message, January 1962, reads:

> "But the greatest challenge of all is posed by the growth of the European Common Market. Assuming the accession of the United Kingdom, there will arise across the Atlantic a trading partner behind a single external tariff similar to ours with an economy which nearly equals our own. Will we in this country adapt our thinking to these new prospects and patterns, or will we wait until events have passed us by? etc."

A Unifying Theme for Action?

Last winter, a private committee of U.S. and Canadian business, labor, and professional leaders issued a Policy Statement Constructive Alternatives to Proposals to U.S. Import Quotas.[6] This expressed the view that what was needed was not simply measures to thwart the proposals, but "new attitudes and actions for dealing with the new competitive challenges signalled by their advocacy." As given in summary form, the Committee's ultimate "new action" reads:

> We recognize the need to attend not merely to the consequences of today's international competition but to its nature. Protectionist pressures in the United States and elsewhere largely reflect the conviction that foreign competition is not fair competition and that restrictive countermeasures are therefore justified. Concern centers on the artificial competitive advantages felt to be granted by special governmental policies and business practices, as distinguished from such inherent competitive advantages as low-cost labor, resources, capital, or technology. This calls for going beyond non-tariff barriers, essential though it is to deal with them right now. It requires coming to grips with techniques by which governments -- our own included -- may in effect subsidize manufacturing or exporting in ways that do not trigger antidumping laws or countervailing duties. These may include governmental sanction or even encouragement of industrial expansion in a key sector to the point of obvious overcapacity, followed, quite understandably, by direct or indirect aids to exports.
>
> We recognize the challenges facing fruitful study of such aspects of international competition. It will encounter obscure but powerful forces and unavoidable disputes over how the word "fair" applies to competition. Yet the issue both involves and concerns many countries, and inaction will open the way for justifiable threats of trade restrictions. These facts suggest that the time is ripe for all industrialized nations to work together toward some international "code of competition." To some extent the European Free Trade Association (EFTA) may offer a useful precedent, its own "rules of competition" having established a modest beachhead, but one that is operational and growing.

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6 Cited in footnote 2 above.

> Perhaps rules of competition merit more than mere inclusion among the next tasks for what we call "International Trade Policy." We may well find that our greatest immediate concern is no longer the degree to which international trade can be made free, but the degree to which the resulting competition can be made both real and acceptably fair. This might even suggest that "International Trade Policy" would be supplemented by, if not incorporated within, "International Competition Policy," a phrase that explicitly identifies the nature of our goals, rather than merely the means by which we have traditionally sought to reach them.

We end this discussion of the gestation period for U.S. trade policy with these paragraphs for two reasons. First, working for "rules of fair competition," as distinguished from negotiating away non-tariff measures, is relevant to defending ground that has been won as well as to covering new ground. It thus offers a unifying theme for action on the two major tasks confronting trade policy making in 1969.

Secondly -- and more important -- there are indications that this concept is being considered seriously. The ideas contained in the quoted paragraphs were taken up by other private groups (most notably the Emergency Committee for American Trade), by the platform drafters of both parties, and to some extent by Congressional and Administration leaders. As the gestation period progresses, we may reasonably expect to hear more about "codes of international competition."

II. WHICH APPROACH TO THE NEXT U.S. TRADE POLICY INITIATIVE?

As mentioned above (I-B-4), U.S. participation in a Free Trade Area appears to be a new possibility that will be considered by the new Administration. This section will compare the traditional multilateral approach to trade liberalization with that of a Free Trade Area, noting the present status of the latter in U.S. thinking and the likely characteristics of such an arrangement if the United States participated. It will then speculate about a comparative evaluation of the two approaches, and end with a personal view of eventualities.[7]

The Multilateral Approach

Since World War II, the United States has channeled its efforts to liberalize trade solely through the multilateral approach. This has involved six rounds of negotiations held under GATT auspices, the most far-reaching being the Kennedy Round. The principle of these multilateral negotiations is universality and nondiscrimination. All GATT members exchange concessions according to unconditional application of the most-favored-nation (MFN) principle, which dictates that concessions granted to one country be automatically extended to all.

The multilateral approach -- unlike that of a formal free trade arrangement -- does not commit participants to a defined goal and a fixed program for reaching it. The extent of concessions made and the breadth of products covered are settled *ad hoc* by the participating countries as key elements in the negotiations. Indeed, negotiating how to negotiate has become the major activity of the multilateral approach, and the cause of its deepest agonies.

Although the six postwar GATT rounds have made substantial progress toward freer trade, the outcome of a given round has, for these reasons, been unpredictable. Negotiations have been prodded by the more eager countries -- notably, the United States -- and by the GATT secretariat. But, ultimately, the pace has been set by those major trading nations least able or willing to offer meaningful concessions. Like a wartime convoy, multilateral negotiations have proceeded at the speed of their least active major participant. Otherwise, unconditional application of the MFN principle would give such a country a "free ride."

The successful conclusion of the Kennedy Round has partially dispelled the premonition, nurtured during its years of frustration, that the multilateral approach had become fatally vulnerable to the presence of laggards among the major trading countries. But, as we scrutinize the next range of tasks, the prospect for adequate progress is far from assured. When the meaning of "trade

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7 Portions of this section borrow from the author's contribution to "The Free Trade Area Concept as Applied to the United States," co-authored by Theodore Geiger and published in *Looking Ahead*, the National Planning Association, October, 1967.

barriers" shifts into non-tariff measures, problems of negotiating how to negotiate arise that far exceed the traditional types of impasses experienced during the Kennedy Round.

For instance, it is difficult to assess the restrictive effect of many non-tariff measures. This encourages exaggerated claims of injury of "unfair competition" and correspondingly exaggerated disclaimers. As a consequence, the sacred concept of reciprocity of concessions for better or worse the guiding principle of past multilateral negotiations, is practically impossible to apply.

Then, as discussed under I-B-3, the new array of trade barriers to be negotiated are typically embedded in domestic legislation. We have noted the serious Constitutional and political problems this raises in the United States. Problems of comparable difficulty, though different nature, appear to exist in other nations, and it is safe to say that few are presently willing and able to make substantial concessions in their non-tariff barriers.

Thus, until the efforts within and among governments open up an area in which nations will agree on how to negotiate their non-tariff measures, the multilateral approach is not so much a convoy stuck by a dead ship as one whose every member finds it difficult to leave port.

The Approach of an "Advance Base" in a Free Trade Arrangement

The uncertainty over the ability of the multilateral approach, first to complete the Kennedy Round and now to break difficult new ground, has been a major factor prompting increasing interest in an alternative approach to moving ahead, establishing a formal free trade arrangement under GATT rules.

While in the multilateral approach all trading partners move as far and as fast as they can together, a formal free trade arrangement would involve -- at least initially -- a more limited group of countries sprinting ahead to establish an "advance base" of completely free trade for virtually all products. In terms of the concepts suggested at the end of the previous section, such a scheme might soon be renamed a "Fair Competition Arrangement," of which the most likely form would be the "Fair Competition Area." (But we shall retain the traditional nomenclature.)

The Present Status of the Concept

In the United States, the official view to date has been that free trade arrangements -- until now all of regional scope -- are desirable to support growth and political integration in Europe and economic development in Latin America, Africa, and Asia. But the they have not been considered preferable to the multilateral approach for the United States itself.[8] However, a small but increasing number of prominent private individuals and groups in the United States have proposed over the past four years that the United States consider participating with other countries in some form of free trade arrangement.[9] The reasoning behind this interest has been varied. As noted above, a major theme has been discouragement with the prospects for the multilateral approach,

8 Back in 1948, before this policy had hardened into doctrine, the United States and Canada are reported to have explored the possibility of a free trade area.

9 Published proposals for one or another type of free trade arrangement as an appropriate approach for U.S. trade policy include: "After the Kennedy Round, What?", a Speech by Howard S. Piquet, Senior Economist, Library of Congress, January 1965; "The United States Should Adopt a Free Trade Strategy," a private paper issued in July 1965 by David J. Steinberg, Chief Economist of the Committee for a National Trade Policy; "The U.S. Role in Britain's Economic Crisis," a speech by Senator Jacob K. Javits at the Savoy Hotel, London, November 1965; A New Trade Strategy for Canada and the United States, a Policy Statement by the Canadian-American Committee of the National Planning Association (U.S.A.) and the Private Planning Association of Canada (Washington, D.C., and Montreal: May 1966); "A Reassessment of Trade Policies," one of the recommendations in The United States Balance of Payments: An Appraisal of U.S. Economic Strategy by the International Economic Policy Association (Washington, D.C.: 1966), pages 146-151; Ralph I Strauss, "A Proposal for New Initiatives in U.S. Foreign Trade Policy," Orbis, Vol. XI, No. 1 (Spring 1967); Thomas M. Franck and Edward Weisband, Eds., A Free Trade Association (New York: New York Univ. Press, 1968).

first provoked during the six-months' paralysis of the Kennedy Round negotiations in 1965. The free trade approach is also seen by some Americans as a desirable new policy if the United Kingdom, having come to feel that it can no longer wait on the doorstep of Europe, shows official interest in such an arrangement.[10] So far, no private study programs in the United States have undertaken such extensive and serious studies of the implications of the Free Trade Area approach as those being completed by the Atlantic Trade Study in England or the Atlantic Economic Studies Program in Canada, though there is talk of the need for such work to be done.

Before we explore whether the Free Trade Area approach will grow from its present modest status in the United States to the point of being adopted as official policy, let us develop some idea of what we are talking about.

The Probable Characteristics of a Free Trade Arrangement Involving the U.S.

The starting point for all formal free trade arrangements is the GATT rules permitting member countries to form such organizations in violation of its basic principle of non-discrimination. Article XXIV reconciles this seeming conflict. Specifically, it allows a group of GATT members to form either a Free Trade Area or a Customs Union but only if they meet four strict standards designed to prevent them from becoming loose preference systems (à la Commonwealth) or a protectionist trade bloc: 1) complete, not partial, elimination of "duties and other restrictive regulations" among its members; 2) commodity coverage accounting for "substantially all the trade" among participants; 3) no increase in restrictiveness of trade barriers against nonmembers; and 4) full development "within a reasonable length of time."

Once respecting these rules, the participants have a wide scope for choices as to specific characteristics. An illustrative checklist of options, grouped by "decision areas," is given in the

10 This view was expressed by Senator Jacob Javits in the Savoy Hotel (London) speech cited immediately above.

first column of the chart on the following page.[11] Only the outcome of actual negotiations would, of course, reveal how these questions would be decided. The choices suggested in the second column appear reasonable, however, for a free trade arrangement in which the United States would participate.

This is not the place to explain all the choices in the right-hand column, but certain salient features deserve a further word.

> The Free Trade Area form is clearly preferable to the Customs Union. It is the more appropriate for countries that wish to limit the degree of policy integration to the bare minimu, and it would be the only form acceptable to the United States. (The Congress finds it difficult enough to share its prerogatives in setting U.S. trade policy with the Executive Branch. One can imagine its reaction to the prospects of sharing them with a number of foreign governments!)

The United States will probably remain uninterested in any "regional arrangement," as this phrase has been understood. It would shun a scheme that would be fulfilled within a geographic area or among a limited "club" of members wherever located. It would consider joining a Free Trade Area only if this step were clearly understood to be the most promising means available for a general trading system encompassing all developed countries and with the association of the developing countries on appropriate terms. All countries would be invited to participate, but since some are unlikely to be in a position to do so immediately, the Free Trade Area might well start among countries within a broad region. But this would be merely an "advance base"with every prospect of growing. For this reason, such words as "Atlantic,""Pacific," etc. are not used here. Among the several present shorthand names for such an arrangement, the most appropriate from the U.S. point of view would probably by MUFTA (Multilateral Free Trade Area).[12] We will thus use this designation for the remainder of the paper.

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11 This reprinted from Theodore Geiger and Sperry Lea, "The Free Trade Area Concept as Applied to the United States," National Planning Association, Looking Ahead, October 1967.

12 Another appropriate name that has been used is IFTA (International Free Trade Area).

POSSIBLE CHARACTERISTICS OF A FREE TRADE AREA INVOLVING THE UNITED STATES*

Major Questions | DECISION AREA | Possible Choices

1. BASIC FORM

a. Choice between Customs Union or Free Trade Area as each is defined in the GATT.
b. If Customs Union: determining the Common External Tariff; if Free Trade Area: handling the "origin problem."

The Free Trade Area form appears clearly preferable for the United States. Rules of Origin would probably be patterned after those used successfully by EFTA.

2. MEMBERSHIP

a. Composition of the initial membership.
b. Provisions for the accession of additional members.
c. Treatment of territories or countries having special trading relationships with member countries (such as the Commonwealth countries have with the United Kingdom).
d. Whether or not the arrangement should be open to additional fully participating members, and to linking with established free trade arrangements.
e. Whether the arrangement should grant to developing countries associate membership with preferential long-term transitional provisions (such as Greece and Turkey have in the EEC).

Geographic scope would be global rather than regional. Thus, the arrangement would be open ended, envisaging the inclusion, sooner or later, of all developed countries as fully participating members. It might be expected that for various reasons the EEC, Japan, Australia, and New Zealand would not be in a position to participate at the outset. In that case, the charter members would be the United States, Canada, and the United Kingdom and other EFTA countries (assuming that they did not enter the EEC). Also in line with its global intent, the arrangement would offer to developing countries associate status under which the full members would open their markets very much sooner to the exports of the associate members than vice versa. The periods of such concessions might vary with the level of development of the associate members.

3. COMMODITY COVERAGE

a. Extent of coverage among nonagricultural products (manufactures and industrial raw materials). This could be all-inclusive (EEC and EFTA) or under a doctrine of "maximum possible coverage," permitting exemptions (Australia-New Zealand Free Trade Area).
b. Handling of nonagricultural products with special situations (most obviously, petroleum).
c. Extent of coverage among agricultural products and close derivatives. If covered, guidelines for common agricultural policies.
d. Various forms of adjustment assistance, seen as an alternative to exemption from commodity coverage of products with acute problems.

Following the precedents of Benelux, the EEC, and the EFTA, the Free Trade Area would probably cover all industrial products and raw materials (with possibly special provisions for petroleum). As an indispensable adjunct to free trade with blanket coverage, we could expect the arrangement to provide various measures—such as adjustment assistance and prolonged timing—to help particular industries and producers meet the threats and realize the opportunities of a wider and more competitive market. Unless the participants were prepared to harmonize their agricultural policies, however, they would exclude this sector, at least at the outset, as did the EFTA.

4. STEPS TOWARD CLOSER ECONOMIC INTEGRATION

a. Purpose of such provisions: limited to providing meaningful free trade (EFTA), or undertaken for its own sake, or even to lead to political integration (original EEC purpose, later opposed by de Gaulle).
b. Approach to "Rules of Competition":
   Handling of government aids to export, production, transport, procurement, etc.
   Restrictive business practices.
c. Approach to policy coordination:
   That concerned with growth and stability (monetary policy, responses to balance-of-payments problems, etc.)
   that related to redefinition of "domestic producer," "export market," etc. in laws affecting dumping, antitrust, and pooled export legislation.

We could expect the arrangement to shun explicit steps toward closer economic integration. It would, however, probably find some "Rules of Competition" to be indispensable to prevent frustration of the benefits expected from free trade by nontariff barriers and by national policies and business practices with preferential effects. Recognizing the need to ensure permanence of the free trade situation, the arrangement might also coordinate certain policies and provide certain facilities to ensure that internal and external imbalances would not be remedied by abrogating free trade.

5. COMMON INSTITUTIONS

a. Basic purpose: limited to serving free trade arrangement (EFTA), or as means to "institutional integration" with political overtones (most especially ECSC, but also EEC).
b. Approach to institution building: fully defined in basic treaty (EEC), or left to be created by the central organ as it deems necessary (EFTA).
c. Powers: voting formulae, possibility of supranational elements.
d. Distribution of powers: single central body (EFTA Council) or in different bodies holding balance of powers (EEC).
e. Techniques for settling disputes.
f. Location of common institutions.

We may assume that the purpose of the common institutions would be limited to the tasks required to operate a simple Free Trade Area. Thus, they would avoid supranational elements and in other ways resemble those of EFTA more than those of the EEC.

6. TIMING ARRANGEMENTS

a. Timetable for abolishing trade barriers among the member countries, including possibility of recognizing special adjustment problems by prolonged or staggered transitional periods.
b. In a Customs Union only: timetable for forming the common external tariff.
c. Timing the entry-into-force of other aspects of the agreement.
d. Provisions for accelerating or delaying the basic timing arrangements.
e. The duration of the free trade agreements a definite expiration or renewal date, or indeterminate.

The timing arrangements incorporated in the agreement would provide for a transitional period to enable reinvestment and restructuring of affected industries. The period should be short enough to prompt everyone concerned to get on with the job, but long enough to allow resources to shift adequately and deliberately. Timing arrangements should also be flexible enough to recognize special adjustment problems in certain industries and countries. Indeed, one effective supplement to adjustment assistance programs would be prolonged transitional periods in certain cases.

* These decision areas and major questions are explored in detail in two publications of the Canadian-American Committee of the National Planning Association (U.S.A.) and the Private Planning Association of Canada: Sperry Lee, A Canada-U.S. Free Trade Arrangement: Survey of Feasible Characteristics (1963) and the Staff Study, A Possible Plan for a Canada-U.S. Free Trade Area (1965). The choices offered here reflect to some extent those developed in Chapter II of the latter publication.

Glossary: ECSC=European Coal and Steel Community; EEC=European Economic Community; EFTA=European Free Trade Association.

Source: Looking Ahead, National Planning Association, October '67.

We presume the purposes of MUFTA would be basically economic and not (as in the EEC) economic integration for its own sake. Thus, MUFTA would (like the EFTA) lean over backwards to avoid any step toward closer policy coordination that did not prove necessary to prevent frustration of its purposes.

At the same time, experience has shown that, to prevent such frustration, a free trade arrangement among developed countries must go considerably beyond merely abolishing tariffs and quotas under Article XXIV of the GATT. The free trade situation must (1) provide for fair competition among the freely traded products, and (2) be a permanent state of affairs. With respect to the first requirement, participants would have to take steps to control the discriminatory effects -- sometimes inadvertent -- of regulations and practice affecting freely traded products. We should therefore expect as a central program of MUFTA some form of "rules of competition" to deal with non-tariff measures. With respect to ensuring the permanence of free trade, members may have to devise mechanisms for harmonizing their domestic economic conditions to enable them to avoid severe problems of internal and external imbalance, or at least to deal jointly with them by means other than the reimposition of trade restrictions.

To summarize by offering a rough working definition of what we are talking about: A free trade arrangement involving the United States would have to take the form of a nonregional, ultimately universal, Free Trade Area in which participating countries would, over a specified time period, completely abolish barriers affecting virtually all mutually traded products, and set such other rules to coordinate policies as may be found necessary to provide fair competition for the freely traded commodities and to preserve the free trade situation despite the changing internal and external conditions of its members.

The Comparative Evaluation of the Two Approaches

We may expect that during the gestation of a new U.S. trade policy some attention will be given to comparing the advantages and disadvantages of the multilateral and the MUFTA approaches to moving ahead.

Are Both Choices Available?

But, before discussing some of these, are there really two options? Some Americans concerned with future trade policy believe not. On the one hand are some MUFTA supporters who see the multilateral approach clearly unable to function on the new range of tasks. Indeed, their argument typically opens with a short obituary for the multilateral approach, which clears the way for presenting MUFTA as the only means for moving forward.

On the other hand are the more numerous "traditionalists," often veterans of previous negotiations and now involved in future planning. They regard U.S. participation in a Free Trade Area with a limited number of countries as involving it in hostile blocs and so definitely "second best" as to merit no serious consideration at this time. Such persons are well aware of the new difficulties faced by the multilateral approach. But they see in the current focus on non-tariff measures within and among governments an agonizing but ultimately successful means to a breakthrough, an effort that should not be distracted by an exciting, but undesirable, alternative.

Interestingly enough, those who reject the Free Trade Area approach out of hand frequently do so as a reaction to the manner of its past advocacy. Frequently presented with a geographic label (most usually as NAFTA, but sometimes as PAFTA or a Hemispheric Free Trade Area), the concept is seen as one satisfied to remain within a region, or among a small group of scattered nations. This impression was encouraged by the original British rationale for NAFTA wherein the U.K., excluded from one region -- Europe -- would join an alternative one of North Arlantic countries. But when the Free Trade Area approach is presented as an alternative means for reaching the traditional U.S. goal of a global trading system, it becomes more generally acceptable by the traditionalists as a possible option for U.S. trade policy. Progress in this direction may be expected now that the British NAFTA supporters are clarifying the global intention of their concept and belatedly exchanging "NAFTA" for "MUFTA."

Are Others Interested?

Another viewpoint states that the multilateral approach may be all that is available to the United States because it is doubtful that any of the candidates for the MUFTA nucleus would wish to take the commercial -- or political -- risks of participating with the United

States in such a arrangement.

The origin of this view is such to suggest that an early move in any serious consideration of the MUFTA approach would be quiet intergovernmental discussions with the principal candidates. If this reconnaisance found most such governments opposed to the MUFTA idea, even in the event that the multilateral approach were to prove incapable of proceeding, we may question whether much more thought to it would be given during the gestation period.

If, however, a potential nucleus group of sufficient number would prove to be interested in pursuing the MUFTA idea with the United States -- if only in the contingency that the multilateral approach failed -- we should expect comparative study of the two approaches to proceed on a number of issues, including the following:

The Effects on Those Countries Not Members at the Outset

Probably no other consequence of MUFTA would be weighed so carefully in the United States as the effects of its formation on those countries unable or unwilling to participate at the outset. If the apparent prospects were that these countries would welcome the open offer of membership and work towards being able to accept it, much of present qualms about MUFTA would disappear. But if it appeared likely that MUFTA would incubate rival blocs with overtones of alienation, the United States would probably shun this approach, even if it promised clear advantages on other counts, unless all other alternatives seemed even less desirable.

Thus, we might expect that the advance reconnaissance, alluded to above, would explore with those nations not likely to join MUFTA initially the prospects for their eventually doing so and their general reactions to the project.

Appropriateness to the U.S. Trade Policy Goals and Principles

While multilateral negotiations and a MUFTA "advance base" may be considered alternative approaches to the same eventual goal, they represent initially very different commitments for the United States. MUFTA would commit the United States to totally free trade by an early date, albeit with a small group of countries at the outset. It would also require a switch in the underlying principle of U.S. trade policy from that of non-discrimination to that of reciprocity. For, in a Free Trade Area, U.S. concessions would not be extended to all countries, but only to those making identical ones to the United States. MUFTA would thus represent changes from traditional U.S. goals and principles to new ones, but ones that Americans have been approaching. Since 1930, the U.S. drive for freer trade has carried the developed countries to within hailing distance of free trade. And recently there has arisen in business circles and in the Congress some question as to the relevance of a relentless U.S. commitment to non-discrimination under the doctrine of unconditional MFN. (One Congressman expressing this sentiment was Robert Ellsworth, recently named by Mr. Nixon to be one of his senior assistants[13]).

The key question, of course, is what fundamental precepts the Nixon Administration will adopt on the two pairs of questions: freer trade or free trade as the ultimate objective of U.S. trade policy, and non-discrimination or reciprocity as the operational principle for getting there. Choice of the first alternative of each pair would favor the decision to stay with the multilateral approach; choice of the latter would heighten interest in the MUFTA.

But we should recognize this as a chicken-and-egg matter. It might well be that a shift to the objective of free trade and the principle of reciprocity would follow the prior conclusion that MUFTA clearly offered the best way to move forward.

Ability to Handle Non-Tariff Measures.

Getting down to practical criteria, this stands to be a key test. Indeed, the strongest case for the MUFTA on practical grounds might arise if it appeared clearly to be the more promising way to make substantial progress in dealing with non-tariff measures.

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13 A shift of the U.S. MFN commitment from unconditional to conditional (upon reciprocity of concessions) was advocated as a move of last resort by Henry S. Reuss and Robert F. Ellsworth in Off Dead Center: Some Proposals to Strengthen Free World Economic Cooperation, Joint Economic Committee, 89th Congress, 1st session (December 1965) pp. 1-7. The reciprocity principle, when expressed in the conditional MFN, is illegal under the GATT. But GATT does permit reciprocity in the form of formal free trade arrangements set up under its specific conditions, summarized on page 10 above.

It is easy to see why such a conclusion might emerge from closer study. By abolishing tariffs, MUFTA would eliminate controversy over methods of valuing and classifying imports for the purpose of setting duties. For barriers unrelated to tariffs, as well as for artificial subsidies to production and transport, the institutional mechanisms of a formally organized Free Trade Area like MUFTA would seem to offer better means for formulating and implementing, solutions than do the *ad hoc* procedures hitherto characteristic of the multilateral approach.

The experience of EFTA appears to support this view. Its "rules of competition" (Articles 13-17 of the Stockholm Convention) are enforceable agreements to exclude certain "government aids" outright and provide for the prohibition of any others that prove, whether by design or quite inadvertently, to frustrate the benefits expected from the Association.

A counter-argument might be: MUFTA's admitted ability to develop workable and enforceable rules of competition would have no effect on the policies and practices of nonmembers, which stand to include those countries employing many of the most troublesome non-tariff measures. This challenge may be answered by the assumption that MUFTA would grow to include all major trading countries in time. But it still raises the nice distinction between effective policy-making and making effective policy, and it emphasizes practical reasons -- to supplement more political ones given above -- for MUFTA's necessity to expand to universal membership.

Effect on North-South Trading Relations

Of critical importance in a U.S. viewpoint would be the comparative implications of the two approaches for North-South trade relations. On this score, the MUFTA would appear to have certain advantages flowing from its common policy base. This would permit its members to act more decisively and concertedly than they would as individual countries. A probable outcome would be to grant "associate status" to all developing countries from the outset. The industrialized members would then open their markets very much sooner -- perhaps immediately -- to the exports of the associates than vice versa. In recognition of the quite different economic levels among the developing countries, there might be some variation in the amount or duration of such special provisions.

Economic Effects on the United States

Studies thus far completed by Balassa, Kreinin and Hawkins[14] show no significant overall economic impact on the United States of participating in a Free Trade Area of the MUFTA kind. But we would expect that certain detailed studies would be made before a decision could be reached as to its domestic acceptability.

A close look would have to be given to the comparative effects of the two approaches on import sensitive industries. Attentions should also be given to appraising the opportunities for the United States to increase its exports of certain products that are sensitive in the markets of potential members. What would be the chances, for instance, for higher U.S. exports of computers? And would U.S. coal move to the U.K., where it is now excluded, and to Canada, where domestic coal benefits from a sizable production and transportation subsidies? The North American endowment of basic raw materials and fuels raises problems not encountered in the European free trade groupings.

What Are the Prospects?

As a result of the evaluation that might take place, along such lines, what future does the MUFTA concept have in U.S. policy? The question is really two fold: whether the United States will shift to it from its traditional multilateral approach, and, if so, when. What follows is, of course, only a personal view.

For the first time now "U.S. Participation in Free Trade Areas" has in the Roth Report been officially considered. And, despite the reluctance of some traditionalists, we may expect it to be examined during the gestation period of Nixonian trade policy. It is not impossible that the MUFTA concept would be chosen as the

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14 Bela Balassa, Trade Liberalization Among Industrial Countries: Objectives and Alternatives (New York: Council on Foreign Relations, June 1967).

Mordechai E. Kreinin, "Effects of an Atlantic Free Trade Area on the American Economy," Southern Economic Journal (July 1966), pp. 96-111.

Robert G. Hawkins, "The Economic Impact on the United States of a U.K.-Canada-U.S. Free Trade Association," in Franck and Weisband, op. cit., pp. 53 ff.

form of the next U.S. initiative, but probably only if it proved unmistakably to be the only way of moving forward. But I would expect, rather, the decision to stay with the multilateral approach if it appeared that the governments could reach agreement in advance on how to negotiate over an adequately large agenda.

Would such a U.S. decision signal permanent U.S. rejection of the Free Trade Area approach? Probably not. Indeed, it might well mean just the opposite.

One eventuality would be that the new round of multilateral negotiations would fail. Perhaps the participants could never reach the point of agreement on how to negotiate. Or, at a later stage, one or more of them might prove unwilling or unable to reciprocate for concessions offered by the others. Such a situation would confront those countries willing and able to move ahead (including, we must always presume, the United States) with the choices of: (1) giving the laggard nation(s) a "free ride"; (2) seeking progress in areas not involving them; (3) shifting their MFN commitments to a conditional basis; or (4) proceeding themselves to form a free trade arrangement under the GATT rules.

Of these options, #1 would require an indifference to the principle of reciprocal concessions that is difficult to envisage, particularly during the heat of negotiations; #2 would promise very little progress unless the reluctant participant(s) were minor traders; #3 would probably mean the end of the GATT as we know it and the onset of a trade war. Only option #4 would offer those wishing to move ahead a means for doing so legally and would probably be taken by the United States unless it were reconciled to seeing the attempt at multilateral negotiations end with failure, and forward movement toward trade liberalization lose steerageway.[15]

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15 During the week following the presentation of this paper, the Roth Report was released to the public with the following conclusion to its discussion of "U.S. Participation in Free Trade Areas":

> The United States should not jeopardize the chance of a further reduction of trade barriers on an MFN basis by proposing or encouraging plans for participation in a new free trade area. It should be prepared to re-examine this position, however, if circumstance should change so as to make it unlikely that a liberal trade policy based on MFN can succeed.

But what if the next round of multilateral negotiations succeeded? In that case, the major trading nations would be so close to free trade that the question "Where do we go from here?" would inevitably assert itself. Many GATT countries would be likely to feel the need to set some specific target date and timetable for completing the process. Moreover -- and probably more important -- the closer the GATT countries came to free trade, the stronger would be their desire to ensure that their accomplishments would be irreversible and they would experience fair competition over the resulting, greatly enlarged, market area. At this point they might all decide to move forthwith to a formally organized Free Trade Area. But, perhaps more likely, we might expect most trading countries to want to undertake a variety of commitments, and to establish the common institutions to implement them, that would duplicate most of the characteristics of one. The participants in a future successful multilateral negotiation might, therefore, come in time to form what amounted to a Free Trade Area through a process of adaptive mutation without having initially launched it, fully rigged, according to the rules and rites of the GATT.

Summary of Prospects for the Free Trade Area Approach

Thus, if you will permit a look to the future that carries to events two jumps ahead -- and, therefore, probably a good deal beyond the five-year outlook assigned to this paper -- I foresee the MUFTA concept as becoming relevant to U.S. trade policy. But this must assume that the United States, joined by a sufficient number of other major trading partners, were determined to move ahead toward a more meaningfully competitive situation. The qualification deserves emphasis, for future trade policy initiatives surely face rough sailing and the irresolute will find more than adequate excuse to give up the quest.

COMMENT ON SPERRY LEA'S PAPER BY BRUCE W. WILKINSON

Sperry Lea's paper is a thoughtful discussion of first the difficulties to be faced by the incoming United States' administration in defining its future trade policy, and second, the possibilities for greater freeing of world trade if clear, bold thinking and action in the face of perplexities becomes the overriding policy of that administration.

Since the paper consists essentially of informed guesses based on an ear-to-the-ground technique, I shall not attempt to comment specifically on the possible realism of these guesses -- except to ask whether the optimism breaking through towards the end of the paper is warranted at this time. My greater concern is to draw attention to two or three issues that are skimmed over too lightly in the paper and to ask Mr. Lea to comment on them if he will.

First, the early pages of the paper are quite pessimistic about new trade liberalization based on U.S. initiatives. Yet there is one possible bright spot that should be noted. Reference is made to the large U.S. corporations operating on an international scale. This paper, as well as a number of others in this conference give all too small a place to these large corporations and their actual and potential impact on world trade and investment. Much of world trade is controlled by these giants. It is in their interests to keep the trade lanes open. Surely they do not want trade policy used as the first line international adjustment mechanism. I would like to ask how much weight Lea would give to the pressures these firms may bring to bear on Congress and the Executive Branch of the U.S. Government and what other implications for world trade relations that he sees from them wishing to pursue their own interests. Will their influence successfully combat protectionist fires fed by the smaller U.S. domestic corporations facing increased imports? Also, what about the influence that these corporations may have on freeing capital investment regulations by other countries?

My second point relates to the statement of the committee of business leaders which is quoted by Lea and which was, apparently, adopted by a number of influencial groups in the U.S.A. It involves a certain fuzziness. It speaks of inherent competitive advantages due to low-labor cost, resources, capital or technology -- as distinguished from artificial competitive advantages granted by government policies and business practices. Yet, technology is a consequence of research and development -- largely subsidized by governments directly or through universities. That is, even though it may lead to a comparative advantage and the product cycle, initially government subsidies are often involved. Therefore, how can we speak of technology as being a non-artificial advantage?

Thirdly, in view of the interest shown by Japan in free trade involving the U.S. it is not clear to me why Japan is specifically excluded in the free trade area proposal that Lea refers to. In answer to Lea's question, "Is anyone else interested in free trade" the answer must presumably be a cautious yes for Japan. I would suggest that the Canadian response might be similar.

Finally, his free trade proposal pretty well eschews agriculture. This is a question raised in one or two subsequent papers so that perhaps discussion of the general issue may be delayed. But it seems to me that the time has come for some bold thinking on this topic too.

COMMENT ON SPERRY LEA'S PAPER BY KUO-SHU LIANG

Mr. Lea's paper is composed of two main parts:

The first part draws out the basic contract between 1961 and 1969, and points out that we may reasonably expect to hear more about "rules of international competition" during the gestation period for future U.S. trade policy.

The second part compares and evaluates the Free Trade Area with the traditional multilateral approach and concludes that the Free Trade Area approach may be presented as an alternative means for reaching the traditional U.S. goal of a global trading system.

Mr. Lea's discussion of the Free Trade Area approach is illuminative. My comments will be confined to the following two points:

Firstly, Mr. Lea emphasized that a free trade agreement involving the United States would have to take the form of a non-regional, ultimately universal, Free Trade Area (p. 35). However, he is of the opinion that for various reasons the EEC, Japan, Australia, and New Zealand would not be in a position to participate at the outset (p.34). I would rather like Mr. Lea to explain the reasons why these countries would have to be excluded at the outset.

Secondly, Mr. Lea stressed that some "rules of fair competition" have to be worked out. However, it seems to me that the rules of fair competition will be assured only if internal as well as external balance can be attained. The chronic trade-balance weakness of the United States has much to do with inflation in the U.S. economy. If the nation has the self-discipline to bring its inflation-bent economy under control, most of its difficulties with foreign competition and pressure for protection should gradually diminish. Otherwise, I am afraid that claims of injury through "unfair competition" will be exaggerated, and what emerges may turn out to be a protectionist scheme rather than a free trade system.

DISCUSSION OF PAPERS BY H. G. JOHNSON AND S. LEA

In reply to comments on his paper, Professor Johnson said that elsewhere he had given emphasis to the role of trade policy as a long run means of permitting the less developed countries to get integrated into the world market structure. In this paper he had been concerned to bring out the role of aid as the major source of external funds for development investment in the shorter run. He said that the net gain from the conversion of domestic resources into foreign resources through trade is much smaller than the total value of the trade. Aid, if it is honest aid, represents net resources. Nonetheless, Professor Johnson agreed with Dr. Kitamura that the role of trade is very important in the structural sense: there has been a tendency to pursue the development problem on the basis of national markets and individual national territories and most of them are far too small to be economically efficient. So that trade is important in setting a structure within which development can be efficient.

Turning to the question of moral commitment and private charity in the aid business, Professor Johnson said that it was true that there was always confusion in Christian charity, which is the major charitable force in the world, between the direct relief of poverty and the overcoming of poverty through establishing people as self-reliant. Professor Johnson felt, however, that just as the United States' poverty programme had come to concentrate more on education, training, and so on, as a means of enabling people to be self-sufficient, those who are concerned on humanitarian grounds with the problems of development have moved on somewhat from the idea that "here are these starving people, we must give them food," to the idea that "here are these economies which can generate enough resources to enable people to live decently and we must change those economies so that they are capable of doing that." It was on that kind of basis that Professor Johnson said that he had envisaged incentives for private aid contributions. This would involve the establishment of United Nations' agencies of various kinds to mobilize private contributions for development expenditure, and it would represent a more ambitious programme for private aid-giving than that to which we have been used. Professor Johnson said that his main concern was that whilst in the past, governments had probably gone beyond what the consensus of opinion was in aid-giving countries about how much money should be contributed, the danger now is that governments will restrict aid below what people would be willing to contribute on the basis of understanding and knowledge of what the problems are.

Finally, Professor Johnson agreed that the real problem for the world economy, upon which the adequate provision of development assistance - both through trade and aid policy - rests is precisely the international monetary problem. Until the monetary problem is solved both trade policy and aid policy will be secondary factors, and regarded as means of adjustment in the balance of payments rather than policy objectives in their own right.

In reply to comments on his paper, Mr. Lea said that there was no doubt in his mind that the international corporations would prove a major force against protectionism. Already, a new group, the Emergency Committee for American Trade (ECAT) has been formed by them to counter protectionist lobbies in Washington. The real question is who will Nixon listen to: the blue ribbon firms backing ECAT or the small domestic producers who are numerous and have close connections with an awful lot of members of the House of Representatives? He said that he, too, was of the opinion that the international corporations would try to link pursuit of liberal trade policies with investment policy, and that there was no country they had more in mind, in the latter connection, than Japan where they had thus far been prevented from extending their operations.

Mr. Lea agreed that in practice the differences between inherent and artificial competitive advantage would be extremely difficult to define. Very few competitive advantages are natural. Most are the result of acquired technology. However, he believed that most of the technological advantage possessed by various industrial producers was probably not subsidized by governments.

Mr. Lea said that he had not meant to suggest that Japan, or any other country, would be excluded from participation in MUFTA. What he had suggested was that it could be expected that Japan, the EEC, Australia, and New Zealand would not wish to participate. That is the feeling in the United States, because Japan still appears concerned to protect its own sheltered markets. If Japan was interested in joining she would have to take two major steps. She would have to dismantle her own tariff and non-tariff barriers to trade and she would probably have to ease restrictions on the establishment of foreign firms. He said that others present could better judge the prospects for Japanese, Australian, and New Zealand participation.

Mr. Lea argued that agriculture was protected not so much against imports as against the normal forces of supply and demand. Agricultural support policy is distinct from trade policy. Most of agricultural policy is designed to protect the farmer. The agonies the EEC went through to devise its Common Agricultural Policy indicate the difficulties of including agriculture in any free trade agreement, unless a Common Agricultural Policy could be devised.

Mr. Lea went on to suggest that boldness was probably one of the important advantages of the MUFTA approach. There are those in Washington who feel that whatever we do in trade policy we have to be bold. There is just so much pressure going the other way that if you once stand still the wolves will descend.

Finally, Mr. Lea argued that a country cannot subscribe to rules of fair competition when its economy is sick. The experience of the response to British surcharges within EFTA emphasizes the responsibilities of members of free trade areas in keeping their economies in order so as to avoid resort to protectionist measures for balance of payments reasons.

Discussion of Professor Johnson's paper centered on the respective roles of aid and trade policies in development assistance. Discussion of Mr. Lea's paper returned to the question of agricultural protectionism and the likelihood of forward-looking trade policies emerging from the United States within the next few years.

Some participants felt that the part to be played by trade policy for an important group of developing countries had been understressed in the earlier discussion. One said that whilst he agreed that the short run payoff from trade growth in terms of the net contribution of foreign resources was likely to be small in general, in the longer run it would be very important. It seemed advisable, therefore, to push the granting of concessions now, when they appeared relatively costless, since in the longer run resistance would be set up to the development of a desirable trade structure. It was further argued that, whilst trade policy might not appear helpful for all developing countries, there were a number of developing countries, among them Korea, Taiwan, Hong Kong, Singapore, India, and Pakistan, who were all expanding manufactured exports rather rapidly and for whom concessions would be very helpful. Others pointed out that not all developing countires were at the same stage of development and that they therefore required different kinds of assistance.

Some participants thought that concentration on efforts to increase agricultural productivity through development assistance would prove of most help to most countries. One said that the emphasis on the granting of trade concessions might even have a disincentive effect on export promotion. But most felt that UNCTAD had served a useful purpose, for developed and developing countries alike, in focussing on the considerable scope for trade expansion and for the provision of improved trading opportunities; and that aid <u>and</u> trade policies were both important and complementary activities.

Asked to comment on the possibilities of graduation from South to North, Professor Johnson said that basically there is an advancing technology in the world economy, and that investments in advancing it are made in those countries where they pay off in one way or another. For most of the world, the question is how close can you get to the most advanced technology. This is partly a matter of knowledge, education, research and the like, and partly a matter of being able to accumulate enough capital or at least get the capital inside your territory through foreign investment. In that context, it is possible to catch up, at least to the level that a lot of advanced countries have caught up, there being, of course, tremendous differences among the advanced countries themselves. Catching-up requires the adoption of the right kinds of policies, but very often that is not always easy. The simplest way to get modern technology is to allow the foreigner to come in and bring it to you with his investment. But that is resented because the foreigner then owns the business. Similarly, resources have to be invested in education. That is not always favoured because it means a change in the whole social structure - for example, a change from a property or land based society to one based on educational attainment. If a country is prepared to pursue policies of this kind - to welcome foreign investment, to lay itself open to learn modern technology, to forget ideas of society based on individual family and so on - then graduation from South to North is perfectly possible.

Mr. Leas's reply to comments on his paper invited comments from other participants. A Japanese participant said that he was unconvinced of the benefits of direct foreign investment for Japan. He suggested that the theory of foreign investment was not very helpful in providing the answers on this issue. For example, what are the implications of the non-equal footing on which United States and Japanese firms face each other? In Japan's case, a high growth rate had been maintained without large direct foreign investment. Indeed, large foreign investment might have produced more serious inflationary effects in a fast-growing economy.

Australian participants said that the distinction Mr. Lea wanted to make between trade policy and farm policy illustrated the difficulties of the GATT approach to world trade policy for countries like Australia and New Zealand, as well as for many of the developing countries. It is precisely the emphasis on the freeing of trade in manufactures among the developed countries and the feeling that agricultural support schemes are not negotiable, indeed, lie outside the realm of trade policy, that has made it so extremely difficult for countries whose principal exports are primary commodities to take with any great enthusiasm trade liberalization along GATT lines. A New Zealand participant, whilst he was unsure of the real significance of European Common Agricultural Policy for exports from his country, agreed that it would be quite impossible politically for New Zealand to enter into a freeing-of-trade which did not allow concessions for trade in primary commodities.

Some participants wondered whether perhaps Mr. Lea had been a little over-optimistic about the possibilities for the emergence of a forward-looking United States' trade policy in the near future. Mr. Lea agreed there were grounds for some pessimism. However, he did not feel that the general quotas that were being asked for by Congress would be adopted because of the potential boomerang effect. Other countries would not acquiesce to quotas without recourse to the GATT procedures for compensation. Compensation could not be granted easily because all the fat had been cut out of the United States' tariff during the Kennedy Round and there remains little to give away without hurting somebody. If. the foreign government was not satisfied with the compensation offered, it could take the second recourse under GATT and retaliate. Because of the boomerang effect, Mr. Lea thought it unlikely that quotas would be adopted. He thought that it was much more likely that the major foreign suppliers of particular commodities would be subject to more persuasion to exercise voluntary restraint. United States' trade policy will probably not become more backward-looking than that. But Mr. Lea concluded that there is the real danger, explained above, that no forward-looking policies will be adopted, and that the momentum in trade policy will be lost.

Part II

TRADE COOPERATION AMONG THE ADVANCED PACIFIC COUNTRIES AND THEIR RELATIONS WITH NEIGHBORING REGIONS

Chapter 3

A RE-ESTIMATION OF THE EFFECTS OF THE FORMATION OF A PACIFIC AREA FREE TRADE AGREEMENT

Bruce W. WILKINSON *

Estimates of the impact of various free trade areas on the trade flows and balance of payments of participating nations are becoming trite. But my terms of reference ask for another look at the Pacific Area Free Trade Agreement from this point of view for the developed countries of the Pacific, so it is to this task that I confine myself.

The paper is divided into four sections. The first discusses two important adjustments to the data that were necessary before PAFTA effects could be considered. These adjustments were for the 1967 devaluations and the Kennedy Round. The second section examines the static trade creation effects of PAFTA. Because of a somewhat different, and I think more appropriate, interpretation of how the import demand elasticities should be applied, the results differ in serveral respects from earlier estimates. In the third section, trade diversion alone as well as the total impact of it and trade creation together are assessed. The final section introduces a number of other considerations, of both a static and dynamic nature, which may alter the preceding results somewhat, but which are fifficult to quantify in any meaningful way.

It is assumed that last year's conference[1] has acquainted participants with the intensity of trade (and changes therein) among

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* I am indebted to Ken Tiedmann for preparing the trade statistics and tariff estimates used in this paper and to Alan Sharpe for all computor work required.

1 See especially the papers by K. Kojima and Peter Drysdale entitled "Japan's interest in Pacific Trade Expansion" and "Pacific Economic Integration: An Australian View" respectively, in Pacific Trade and Development: Papers and Proceedings of a Conference held by the Japan Economic Research Center (January, 1968).

the PAFTA developed nations, both absolutely and relative to trade intensity with other regions of the world, so that space need not be devoted to this topic. Apart from a few comments on agriculture, purely political issues are not given any attention in this paper.[2] Also, for brevity, any assumptions used that are the same as those in my previous paper on PAFTA[3] will be given short shrift.

I. ADJUSTMENTS

Although the full Kennedy Round tariff reductions will not be completed until 1972, some measure of the relative changes in the flows of goods among PAFTA countries emanating from this source may be obtained by applying the usual static elasticities approach to the available trade data. The weaknesses in this approach are well known,[4] so that space need not be devoted to them. But a few comments on the particular data and assumptions employed in these adjustments as well as in subsequent sections of this paper may be useful. First, consider the data. Five major commodity divisions were used: 1) crude foodstuffs, 2) processed foodstuffs, 3) crude materials, 4) semi-manufactured non-foodstuffs, and 5) finished manufactures and chemicals. Within these five divisions 125 SITC groups were distinguished, some at the four digit level where such detail was warranted.[5,6] Neither agricultural goods nor fuels were excluded. Although there are numerous non-tariff restrictions affecting these two groups, there are also many such restrictions upon trade in manufactured goods ranging from government buy-at-home policies to subsidization of research and development. Consequently, it seemed inappropriate to arbitrarily exclude the former commodities.

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2 For more politically oriented discussions, see the series entitled The Atlantic Trade Study (London: England).

3 Canadian Trade, The Kennedy Round and a Pacific Free Trade Area, in Pacific Trade ... pp. 30-71.

4 Eg. M. Kreinan, Alternative Commercial Policies--Their Effect on the American Economy (East Lansing, Michigan: Graduate School of Business Administration 1967), pp. 40-42.

5 See Appendix for the list of SITA groups.

6 All trade data is from the import statistics of each country as shown in U.N. commodity trade reports for 1966.

GATT tariff rates and where appropriate, British preferential rates,[7] for both prior to and after the Kennedy Round were estimated for each group by unweighted averaging of the individual applicable rates.[8,9] Rates for Australia, Canada and the United States were adjusted downward 10 percent to allow for imports being recorded f.o.b. rather than c.i.f. Other adjustments were also made for the American selling price regulation and the Canada-United States auto pact.[10] Nominal, not effective, tariffs were used throughout these and all following computations. This is appropriate when using the direct method of applying elasticities of demand for imports to the tariff changes--as was done here.[11]

Apart from the Ball-Marwah [12] estimates of import demand

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7 In some instances the rates prevailing among Australia, New Zealand and Canada as a result of bilateral agreements between these nations differ from their British preferential rates. However, for simplicity the British Preferential rates were used throughout.

8 Rates were taken from the International Customs Journal and the GATT reports on the Kennedy Round reductions. My computations for last year's conference were of necessity based on sketchy and incomplete information.

9 Peter Drysdale and Harold Cowie were kind enough to let me have the tariff rates that they had derived for a number of the nations relevent to this study, but as I was not certain of receiving them I had, in the meantime, set my research assistant to the task of developing the ones used in this paper.

10 See B. Wilkinson in Pacific Trade ...., p.43.

11 Balassa found that the differences in trade changes resulting from using the above method as opposed to the indirect approach involving domestic elasticities of demand for importables and supply of value added of importables as well as both nominal and effective rates were generally small and never in excess of 10 per cent; see Trade Liberalization Among Industrial Countries: Objectives and Alternatives (New York: McGraw Hill, 1967), pp.77. Moreover, the assumptions required in arriving at effective rates make it extremely questionable that they can be used with any precision or confidence in estimating effects of tariff reductions; see J. Melvin and B. W. Wilkinson, Effective Protection in the Canadian Economy, for the Economic Council of

elasticities for the United States, estimates of these elasticities for the developed nations of PAFTA for recent years are either not available or at least do not conveniently fit the commodity classification employed. To provide some idea of the sensitivity of the results to the elasticities used, three sets of elasticities were thus assumed for each country. For the United States the Ball-Marwah estimates were taken as the medium elasticities; these plus two standard errors were used as the high set and when divided by two comprised the low set. Japan's elasticities were assumed to be three-quarters those of the United States, whereas those of Canada, Australia and New Zealand were assumed to be one-half the American ones. These relations among the elasticities for the PAFTA countries are largely in accord with Balassa and Kreinan's[13] approach. Table 1 summarizes these assumptions and indicates the weighted average elasticities of demand for total import by each country implied by them. The weights used were the shares of the commodity divisions in total imports for the country concerned.

One or two comments about the weighted averages are necessary. First, because of the high proportion (about 75 percent) of crude and semi-processed materials in Japanese imports, the averages for Japan are less than for New Zealand, Australia and Canada even though, for any one set of elasticities the individual elasticities used for each Japanese commodity group are higher. Second, for the United States, the Ball-Marwah average for what I have called medium elasticities was -1.3, substantially less than our number of -2.02. The difference seems to occur partly because they placed fewer commodity groups in the highly manufactured (high elasticity) commodity division than has been done here, and partly because their weights are based on trade over the years 1948-1958 whereas I used 1966 imports, involving a greater proportion of highly manufactured goods. Finally, regarding New Zealand, recent evidence suggests that the third, low set of elasticities are the most appropriate. Stephen Turnovsky's work,[14]

(11 cont'd) Canada (Ottawa: Queen's Printer, 1968).

12 "The U.S. Demand for Imports, 1948-1958", Review of Economics and Statistics, 44 (November, 1962), pp. 394-401.

13 "Trade Liberalization Under the 'Kennedy Round': The Static Effects", Review of Economics and Statistics, 49, (May, 1967) pp. 126-128.

14 "International Trading Relationships for a Small Country: The Case of New Zealand", Canadian Journal of Economics, I November, 1968), pp. 772-790. See espec. p.788.

TABLE 1

ELASTICITIES OF DEMAND FOR IMPORTS

	Crude Food-stuffs & Feed			Processed Food-stuffs & Feed			Crude Materials			Semi-Manufac-tures (non food)			Finished Manu-factures & Chemi-cals & (non food)			Weighted Averages		
	High	Medium	Low	High	Medium	Low	High	Medium	Low	High	Medium	Low	High	Medium	Low	High	Medium	Low
USA	-.73	-.34	-.17	-3.43	-1.87	-.94	-.65	-.26	-.13	-2.15	-1.38	-.69	-5.28	-.350	-1.75	-3.20	-2.02	-1.01
Japan	-.54	-.26	-.13	-2.67	-1.40	-.71	-.48	-.20	-.10	-1.62	-1.04	-.52	-3.96	-2.63	-1.31	-1.26	- .74	- .40
Canada																-1.84	-1.18	- .60
Australia	-.37	-.17	-.09	-1.72	- .94	-.47	-.33	-.13	-.07	-1.08	- .69	-.35	-2.64	-1.75	- .88	-1.74	-1.12	- .56
N.Zealand																-2.01	-1.31	- .66

Source: See Text.

Notes: (1) Weights are the shares of the commodity divisions in total imports of the country concerned.

covering the years 1947-1963, gives a price elasticity of demand for imports varying between -.08 and -.51. Such low numbers seem reasonable when it is recalled that about 50 percent of New Zealand's imports are producers' materials for use in manufacturing, another 25 percent is capital equipment and 7 percent is fuels.[15]

The foregoing comments are relevant for subsequent sections of this paper as well as the present one. But there are a few additional remarks that are particularly relevant when estimating the trade impact of the Kennedy Round.

Since few of Canada's British Preferential tariffs were reduced compared with the number of her GATT rates that were reduced, it will mean a lowering of the margins of preference in the Canadian market formerly enjoyed by the United Kingdom on a wide range of commodities. The trade diversion effect of the preferential system will to this extent be reduced. But since only about 6 percent of Canadian imports at present come from the U.K. the expansion of Canadian imports from the other members of PAFTA from this cause is not likely to be very great in either absolute or relative terms. No adjustment has been attempted at this juncture.

The number of SITC commodity groups on which Australian GATT tariffs were reduced was small (about 17) and the tariff changes for these groups generally averaged but a fraction of a percentage point. The changes in British preferential rates were similarly minor and some were even increases from the previously published rates. Consequently, no adjustment was made in Australian imports for the Kennedy Round.

New Zealand lowered her GATT tariffs on a larger number of SITC groups than did Australia (Nearly 40). On less than one-half of these her British preferential rates were reduced too. It was assumed that any increase in imports from Australia and Canada that might be stimulated by the lowered BP rates would be roughly offset by the reduction in trade diversion that would now occur because of a lowering of substantially more GATT rates than BP rates. Hence, net changes in imports of New Zealand from Canada and Australia were assumed to be negligible. New Zealand import

15 Ian A. McDougall, "The Prospects of the Economic Integration of Japan, Australia and New Zealand", in Pacific Trade ..., Table III, p.137.

quotas were also ignored at this stage. By disregarding their inhibiting effect, we may have overstated the rise in New Zealand imports emanating from the Kennedy Round.

The formula used for the computations is well-known.[16] In applying it, perfectly elastic supplies of export goods by each nation are assumed.[17]

Summary results of the static effects of the Kennedy Round on the trade flows among the PAFTA countries[18] are presented in Table 2. Japan will enjoy the largest absolute and relative expansion of exports within PAFTA and the largest net improvement in her trade balance with the PAFTA countries. United States is at the other extreme and would face the greatest absolute and relative growth of imports. It is also the only one of the five nations that would experience a worsening of her trade balance with the PAFTA group. The average expansion of trade among the PAFTA nations is about 7-1/2 percent, 5 percent and 2-1/2 percent if the high, medium and low elasticities respectively are used by all countries.

It is also possible to see from the table how the results would be altered if the most unfavourable (favourable) circumstances were faced by any one country. If, for example, the highest import demand elasticities applied to the United States, yet its exports faced the lowest elasticities by the other four nations, its trade balance with PAFTA could worsen by about $US 900 millions. If the converse were true, its trade balance would improve by about

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16 i.e. $dM = E_m . M . \frac{t-t'}{1+t}$; where dM = change in imports
E_m = the importing country's relative price elasticity of demand for imports,
t and t' = the pre- and post- Kennedy ad valorem tariff rates.

17 It is convenient to leave the discussion of this assumption until the following section.

18 As the results are not of as much interest at this juncture, changes in trade with non-PAFTA countries are not reported here. We have estimated, however, the increases in imports by PAFTA nations from the U.K. and the rest-of-the-world as a consequence of the Kennedy Round as these are required when computing the trade diversion effects of PAFTA.

TABLE 2

STATIC EFFECTS OF KENNEDY ROUND ON TRADE AMONG PAFTA COUNTRIES

Country	Increase in Exports to PAFTA		Increase in Import from PAFTA		Net Change in Trade Balance
	Millions of $ US	%	Millions of $ US	%	Millions of $ US
(A) HIGH ELASTICITY ESTIMATES					
New Zealand	30.2	8.57	2.9	0.68	+ 27.3
Australia	39.7	3.03	0.0	0.0	+ 39.7
Canada	372.9	5.83	321.5	4.85	+ 51.4
Japan	678.2	19.39	244.7	6.29	+422.5
United States	519.4	5.24	1071.3	11.55	-551.9
TOTAL	1640.4	7.65	1640.4	7.65	
(B) MEDIUM ELASTICITY ESTIMATES					
New Zealand	18.2	5.16	2.0	0.47	+ 16.2
Australia	21.8	1.67	0.0	0.0	+ 21.8
Canada	237.6	3.71	209.3	3.16	+ 28.3
Japan	446.7	12.77	155.6	4.00	+291.1
United States	337.0	3.41	694.4	7.49	-357.4
TOTAL	1061.3	4.94	1061.3	4.94	
(C) LOW ELASTICITY ESTIMATES					
New Zealand	9.1	2.58	1.0	0.23	+ 8.1
Australia	10.9	0.83	0.0	0.0	+ 10.9
Canada	118.8	1.86	105.3	1.59	+ 13.3
Japan	224.2	6.41	77.6	1.99	+146.6
United States	169.2	1.71	348.1	4.14	-178.9
TOTAL	532.2	2.48	532.2	2.48	

NOTE: Totals in this and all subsequent tables may not add due to rounding.

$US 170 millions. The average of these extremes is not far removed from the results obtained by using medium elasticities for all nations.

The New Zealand devaluation of 19.4 percent must be allowed for as well. Using the same level of detail as before, the same elasticities and basic methods and the computed post-Kennedy trade flows, the changes in New Zealand imports and exports, valued in $US, were estimated. These changes, insofar as they relate to trade with PAFTA countries, are presented in Table 3.[19] As indicated earlier, the lowest New Zealand import elasticities are likely the most realistic. And if the medium set of elasticities are most appropriate for the remaining nations, then New Zealand's trade balance with PAFTA countries would improve by a modest $US 90 millions. Imports from PAFTA would have diminished by 14 percent and exports would have risen by 8 percent.

II. TRADE CREATION EFFECTS OF PAFTA

Previous estimates[20] of the trade generated by PAFTA have been derived by applying elasticities somewhat similar to those assumed in this paper to the tariff reductions and trade flows within the PAFTA countries. The results are a first approximation to the trade creation effects of PAFTA. But ignored in these earlier calculations is the fact that the elasticities employed are estimates of each country's elasticities of demand for total imports, in the commodity group or division concerned, from the rest of the world, not

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19 The alterations in New Zealand imports from U.K. and the rest-of-the-world were also estimated as the results are necessary for trade diversion estimates. The U.K. devaluation of 14.3 percent was allowed for in these computations as well. Moreover, the effects of the U.K. devaluation on imports by the other four PAFTA nations from the U.K. were also computed as these results too are needed in the trade diversion calculations.

20 See espec. K. Kojima, "A Pacific Economic Community and Asian Developing Countries", Hitotsubashi Journal of Economics (June, 1966), pp.   : also "Japan's Interest in the Pacific Trade Expansion", in Pacific Trade ..., pp. 163-167. See also P. Drysdale, "Pacific Economic Integration, An Australian View", in Pacific Trade ..., pp. 205-207 and B. Wilkinson, "Canadian Trade, The Kennedy Round and a Pacific Free Trade Area", also in Pacific Trade ..., pp. 48-54.

TABLE 3

STATIC EFFECTS OF NEW ZEALAND DEVALUATION ON THE BALANCE OF TRADE WITH PAFTA COUNTRIES

1966

(Millions of $ US)

(a)

	Imports from					Export to					
Elasticities	Australia	Canada	Japan	U.S.A.	PAFTA	Australia	Canada	Japan	U.S.A.	PAFTA	Total Improvement in New Zealand Balance of Trade
High	-79.0	-17.8	-32.8	-53.8	-183.4	7.1	0	13.5	88.8	109.4	+292.8
Medium	-51.8	-11.6	-21.5	-35.1	-120.0	1.3	0	- 2.8	30.2	28.7	+148.7
Low	-26.1	- 5.6	-10.8	-17.6	- 60.3	-3.9	0	-12.5	-8.3	-24.7	+ 35.6

(b) Percentage Change in New Zealand Trade Flows

Elasticities	Decreases in Imports	Increases in Exports
High	43	28
Medium	28	8
Low	14	-7

just from PAFTA nations.[21] Elasticities of demand for imports from PAFTA nations alone will therefore be higher than these estimates and accordingly trade creation will be greater.[22]

If we had detailed import price elasticities for each commodity division for each PAFTA nation from each of the other PAFTA nations, these would be the logical values to use. Only a few of these are available so that to take this approach would require a new set of "guestimates". Rather than doing this, I first apply the elasticities for imports from the world by each PAFTA country to PAFTA trade alone. This provides a first approximation to trade creation comparable with earlier such calculations. Then, using the same elasticities I consider what the extra potential increment in imports by each country would have been had its tariff reduction been vis-a-vis the rest-of-the world as well. It is assumed that because of product differentiation (English bone china, Danish furniture, French wines etc.), a portion of this extra increment is not available from other PAFTA countries and therefore cannot form a part of the total trade creation effect. This has the same effect as assuming perfectly inelastic supply of these goods within PAFTA and no substitutability between them and products available within PAFTA. The remaining proportion of imports is assumed to be in perfectly elastic supply in the other PAFTA countries and is allocated among them in proportion to their share of imports in each of the five commodity divisions for the country concerned.[23]

For the United States, one-half of the extra potential increment in imports for each commodity division are assumed not available within PAFTA. Therefore the total net increment in imports by the United States from PAFTA is assumed to consist of the first approximation effect resulting from applying the import demand elas-

21 This is not a problem with respect to the Kennedy Round adjustments because trade with most of the world was involved.

22 Neglecting the possible complications of product differentiation and less than perfectly elastic export supplies, it can easily be shown that the import demand elasticity for any one PAFTA nation for imports from the rest of PAFTA is greater than that country's elasticity of demand for imports from the world by the ratio of the import volume from the total world to import volume from PAFTA. Or, in other words, it will be large enough that the increment in imports that that country would absorb from the rest of PAFTA would equal the total increment that it would have absorbed if it had lowered its tariffs on imports from the entire world.

23 See Appendix Table A - 4 for these shares.

ticities in Table 1 to the tariff removal and trade flows within PAFTA, plus 50 percent of the extra potential trade creation effects.

For countries other than the United States, which can thus import from the large, diverse and technologically advanced American market, it is assumed that only 25 percent of the extra increases in imports that may arise will not be obtainable from within PAFTA.

The assumption of perfectly elastic supply of exports by PAFTA nations deserves comment. Because exports, and the changes in exports, due to PAFTA that United States will face, comprise such a small percentage of total U.S. output, it seems very appropriate to assume perfectly elastic export supplies for that country. As for Australia, New Zealand and Canada, these countries hope to achieve economies of scale and greater productivity through production for export. This result, if obtained, would give a downward bias to prices. Only if bottlenecks arose or a general factor price rise occurred because of full employment and inflation generated by much improved trade balances, would the tendency be for export prices to rise noticeably. But to anticipate the results, such pressures are very unlikely for Australia (who faces a substantial worsening of her trade balance) and New Zealand (who will probably have but a small improvement in her trade balance). Although Canada will enjoy some net improvement, its extent is modest, particularly when compared with the much larger expansion of net exports to United States resulting from the auto pact alone and accompanied by a decline in Canadian export and domestic prices as a consequence of the improved productivity. Moreover, labour force growth rates in Canada are expected to continue high in relation to such growth rates in other developed countries. For Japan, the assumption of constant export prices in the presence of a large net expansion in exports may seem somewhat unrealistic. But as I shall repeat again later, the net expansion would be less and the numbers of people available for work in manufacturing would be greater if the easing of import restrictions on agricultural products were undertaken as a valid part of any free trade agreement that may be negotiated. Hence I retain the assumption of perfectly elastic export supplies for that country too.

One or two final remarks about the computations are necessary before turning to the results. First, notice that no provision has been made for the Australian-New Zealand Free Trade Agreement. The impression gained from the assessments of this agreement to date are that apart from the pulp and paper, the impact is not expected to be large. But my omission nevertheless means that the effects of PAFTA are overstated insofar as trade between these two countries is concerned. Second, no allowance has been made for the reduction in trade diversion which might have existed prior to PAFTA because of British Preferential tariffs existing among the three Commonwealth countries in PAFTA. The very modest increases in imports by each of these three nations from the United States and Japan that would result from the elimination of British Preference are ignored.

Summary results for the first approximation static trade creation effects of PAFTA are shown in Table 4. Kojima's estimates for PAFTA, Drysdale's for Australia and my own earlier one's for Canada (all based on 1965 trade) are also shown. Variations between the earlier values and those from this paper can be explained largely by the different adjustments made and elasticities employed. For example, my more favourable results than Kojima's for New Zealand as well as for Australia and Canada owe much to the preliminary adjustment made for devaluation with respect to the first country and to lower assumed import demand elasticities for the latter two nations. The greater improvement in trade balance for Japan that is shown by Kojima undoubtedly can be attributed, to a large extent, to the Kennedy Round benefits included in his calculations but excluded from ours.

The total expansion of PAFTA trade from these first approximations is \$4.5 billions, \$2.8 billions, or \$1.3 billions depending upon whether the high, medium or low elasticities are accepted. The percentage increases in trade represented by these numbers are 19, 12 and 6 respectively. These are fairly modest static effects, especially when considered in relation to the average rates of increase in world trade over the past 7 or 8 years of about 8 percent.

<u>Total</u> static trade creation effects of PAFTA are set out in summary form in Tables 5(a), (b) and (c). Consider the situation for the five countries in turn.

For New Zealand, the net trade balances for the different elasticities are little changed from the first approximations. These figures conceal, however, that New Zealand's imports from PAFTA rise more rapidly than do those of any of the other countries except Australia, and that its export rate of increase is second only to that

TABLE 4

FIRST APPROXIMATION TO STATIC TRADE CREATION EFFECTS OF PAFTA ON THE BALANCE OF TRADE OF THE DEVELOPED COUNTRIES
(Millions of $ US)

Elasticities	New Zealand	Australia	Canada	Japan	United States
High	+64.5	-455.1	-552.5	+1024.3	-81.2
Medium	+5.8	-309.1	-378.2	+658.2	+23.3
Low	-10.3	-153.4	-190.5	+307.7	+46.5
Kojima	-117.6	-586.1	-625.4	+1312.4	+18.5
Drysdale		-564.0			
Wilkinson			-439.0		

Sources:
First 3 rows: see Appendix Table A - 5.

Row 4: see "Japan's Interest in the Pacific Trade Expansion", in Pacific Trade and Development: Papers and Proceedings of a Conference held by the Japan Economic Research Center in January, 1968, Table 9, p. 186. The import demand elasticities he used were essentially between our medium and high elasticities for the United States and Japan and above our high elasticities for the other three countries.

Row 5: "Pacific Economic Integration: An Australian View", in Pacific Trade... Table 2, p. 207. The elasticities used were the same as Kojima's with some adjustments based upon particular studies for Australian exports.

Row 6: "Canadian Trade, The Kennedy Round and A Pacific Free Trade Area", in Pacific Trade...., Table 4, p. 53. The elasticities used were the same as Kojima's for United States and Japan and just slightly above the medium ones in this present paper for the three other countries.

TABLE 5

TOTAL STATIC TRADE-CREATION EFFECTS OF PAFTA

(a) On the Balance of Trade of the Developed Countries

Elasticities	New Zealand	Australia	Canada	Japan	United States
High	+62.0	-851.0	+376.0	+1587.5	-1174.5
Medium	-11.9	-563.6	+160.4	+1015.6	-600.5
Low	-25.5	-273.9	+54.9	+474.1	-229.7

Source: Appendix Table A - 7

(b) On the Exports and Imports of PAFTA Countries, Percentage Increases Based on Adjusted[1] 1966 Trade

Elasticities	New Zealand		Australia		Canada		Japan		United States		Total PAFTA
	X	M	X	M	X	M	X	M	X	M	
High	40.0	60.1	20.3	89.3	26.9	20.7	64.6	25.7	29.0	40.1	34.5
Medium	24.2	38.2	11.7	57.7	16.3	13.4	42.1	15.4	18.6	25.0	21.5
Low	11.7	18.9	6.2	28.5	7.7	6.7	20.8	7.3	9.2	12.0	10.5

Source: Appendix Table A - 6

Notes: [1]Adjusted for the Kennedy Round and New Zealand devaluation.

(c) On Trade by Major Commodity Divisions (High Elasticities)

Commodity Division	Trade Creation Millions of $ US	%
Crude Foodstuffs	194.5	13.7
Processed Foodstuffs	443.0	42.4
Crude Materials	113.5	3.3
Semi Manufactures	414.8	14.9
Finished Manufactures and Chemicals	6781.5	47.4
Total	7947.3	34.5

Source: Appendix Table A - 8

of Japan. Flexibility will be required in the conomy if resources are to shift as required by these trade increases. More important is that even though prior adjustment was made for the New Zealand devaluation, the country probably stands to lose--in static balance of trade terms--from PAFTA. And if the devaluation was not sufficient to permit removal of the extensive import quotas (which have been ignored in the foregoing calculations)[24] then a free trade arrangement which requires their elimination too, might make the New Zealand position even more unfavourable.

From a balance of trade viewpoint, Australia comes off the worst, at least relative to the size of its existing trade flows. It has the highest rate of increase in imports and the lowest rate of increase in exports (58 percent and 12 percent respectively for the medium elasticities). These increases are the result of the commodity and area composition of Australian trade. Of the five developed PAFTA countries it has the largest proportion of its imports from PAFTA (about 85 percent) in the highly manufactured group (which has the highest import demand elasticity), and the largest proportion of its exports to PAFTA (about 60 percent) in crude foodstuffs and crude materials (which have the lowest elasticities).[25] Australia supplies only 2.5 percent of Japanese imports from PAFTA of highly manufactured goods and only .5 percent of US imports from PAFTA in the same category. Hence she gains relatively small amounts from the extra trade creation of PAFTA which are largely concentrated in the highly manufactured goods division. Yet her imports rise substantially, so that her trade balance with PAFTA may become worse by over one-half a billion $US--if the medium elasticities apply.

The Canadian position is quite different from that presented under the initial approximation to PAFTA. Her trade balance now improves (rather than worsens), primarily because she supplies 60 percent of <u>all</u> U.S. imports from PAFTA countries and 50 percent

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24 If, in fact, the devaluation was sufficient to correct New Zealand's overvalued currency and permit discontinuance of the quota system without any great net worsening of New Zealand's trade balance, then it is quite correct to disregard these quotas in the PAFTA discussion. As for the dynamic issues involved, see the final section of this paper.

25 See Appendix Tables A-2 and 3.

of all U.S. imports from PAFTA of finished manufactures and chemicals. Hence she is a main beneficiary of the extra increments in U.S. imports. At the same time, because 75 percent of her imports are from PAFTA nations, the major rise in her imports resulting from PAFTA was already picked-up in the first approximation effects.

Japan has by far the most to gain from the static trade creation effects of PAFTA. Its exports will enjoy the highest rate of growth of any of the PAFTA countries and its import growth will be the second lowest. (It has the highest proportion of its exports to PAFTA in the finished manufactures and chemicals category--88 percent--and the lowest proportion of its imports from PAFTA in this category --24 percent--of any of the PAFTA countries).[26]

For the United States a substantial worsening of her trade balance with the PAFTA countries is the result--primarily because of the sizeable net expansion in imports of finished manufactures and chemicals from Japan and Canada. And if it had been assumed that even more than 50 percent of the "extra" potential U.S. imports were available within PAFTA, the U.S. position would be even more unfavourable than here presented.

In terms of commodity divisions, finished manufactures and chemicals will, as expected, experience the greatest increase both in absolute and relative terms. Using the high elasticities, for example, 85 percent of the trade creation impact of PAFTA will be in this category of products. The rate of increase would be over 47 percent. (Table 5(c)) For all products the trade expansion would be $US 7.9 billions, $US4.9 billions or $US2.3 billions depending upon whether the high, medium or low elasticities are appropriate. The percentage rises in trade corresponding to these magnitudes are 35, 22 and 11 respectively. (See Appendix Tables A-6 and A-7.)[27]

III. TRADE DIVERSION

To the above estimates must be added the amounts by which imports that have been from outside PAFTA will now emanate from

26 See Appendix Tables A-2 and 3.

27 Changes in trade balances between individual countries are also to be found in the Appendix tables.

other PAFTA nations as a consequence of the tariff removal. To allow for these changes an elasticity of substitution has been applied for each PAFTA country with respect to imports from the remaining PAFTA countries as opposed to imports from the rest-of-the-world. The diversion effect has then been allocated among these remaining countries, according to the shares of these nations, by commodity group, in the imports of the country under consideration prior to PAFTA trade creation effects being estimated. The computations have been made using, first, an elasticity of substitution of unity and then of two.[28]

Summary trade diversion effects are presented by country and commodity in Tables 6(I) and (II). The total impact amounts to $U.S. 790 millions, or 3.4% of adjusted 1966 intra-PAFTA trade if the elasticity of substitution is unity and nearly $U.S. 1600 millions or 7% if the elasticity equals two. These diversion effects contribute to the improvement in trade balance for those countries --Japan and Canada particularly--that ended up with a net increase in exports over imports because of the trade creation effects. They also reduce to some extent the unfavourable changes occurring in the balance of trade of the remaining countries. These benefits are shown in the "increase in exports to PAFTA" columns of Table 6. (The "imports" columns merely show the extent to which the individual countries divert their imports from abroad to intra-PAFTA sources of supply.) Finished manufactures and chemicals account for about 70% of the diversion in absolute terms. Diversion is greatest relative to trade flows in crude foodstuffs where it equals 4.9% of PAFTA imports of such goods when the elasticity of substitution is assumed to be unity and 9.5% when the elasticity is two.

Total trade creation and trade diversion effects of PAFTA are summarized in Tables 7(I) and (II). The total rise in exports of PAFTA countries to one another may reach as high as 38 to 41%[29] if the high elasticities were applicable. (For the medium and low elasticities the percentages would be about 25-29 and 14-17 respectively.) The greatest gain in exports is registered by Japan--72 to

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28 See Appendix B for derivation of the formula for the trade diversion effect using an elasticity of substitution.

29 Depending upon whether the elasticity of substitution were 1 or 2 respectively.

TABLE 6

SUMMARY TRADE DIVERSION EFFECTS OF PAFTA

(I) Elasticity of Substitution = 1 and Based upon High Import Demand Elasticities[1]

(A) By Country

Country	Increase In Exports To PAFTA		Increase In Imports From PAFTA		Net Change In Trade Balance With PAFTA
	MILLIONS OF $ US	%[2]	MILLIONS OF $ US	%[2]	
New Zealand	24.8	4.6	23.3	9.4	+1.5
Australia	42.3	3.3	170.3	13.7	-128.0
Canada	161.1	2.4	119.7	1.7	+41.4
Japan	241.4	5.9	125.9	3.0	+115.5
United States	319.6	3.1	350.1	3.4	-30.5
Total	789.3	3.4	789.3	3.4	0

(B) By Major Commodity Division

Commodity Division	TRADE DIVERSION	
	MILLIONS OF $ US	%[2]
Crude Foodstuffs	69.6	4.9
Processed Foodstuffs	46.4	4.4
Crude Materials	53.2	1.5
Semi-Manufactures	60.2	2.1
Finished Manufactures and Chemicals	559.6	3.9
Total	789.3	3.4

TABLE 6 (concluded)

SUMMARY TRADE DIVERSION EFFECTS OF PAFTA

(II) Elasticity of Substitution = 2 and Based upon High Import Demand Elasticities.[1]

(A) By Country

Country	Increase in Export to PAFTA: Millions of $US	Increase in Export to PAFTA: %[2]	Increase in Import from PAFTA: Millions of $US	Increase in Import from PAFTA: %[2]	Net Change in Trade Balance with PAFTA
New Zealand	50.4	9.4	48.1	19.4	+ 2.3
Australia	86.6	6.8	354.0	28.5	-267.4
Canada	324.4	4.8	233.6	3.4	+ 90.8
Japan	492.7	12.0	248.5	6.0	+244.2
United States	639.1	6.2	708.9	6.8	- 69.8
TOTAL	1,593.2	6.9	1,593.2	6.9	0

(B) By Major Commodity Group

Commodity Division	Trade Diversion: Million of $US	Trade Diversion: %[2]
Crude Foodstuffs	135.2	9.5
Processed Foodstuffs	93.8	9.0
Crude Materials	107.4	3.1
Semi Manufactures	122.4	4.4
Finished Manufactures and Chemicals	1,134.3	7.9
TOTAL	1,593.1	6.9

Source: Appendix Tables A-9 and 11.

Notes: (1) For results based on medium and low elasticities see Appendix Table A-10.
(2) Based on 1966 trade after adjustment for Kennedy Round and New Zealand devaluation.

TABLE 7

TOTAL TRADE CREATION AND TRADE DIVERSION EFFECTS OF PAFTA

(I) Elasticity of Substitution = 1 and Based upon High Import Demand Elasticities

(A) By Country

Country	Increase In Exports Of PAFTA		Increase In Imports Of PAFTA		Net Change In Trade Balance With PAFTA	Net Change In Trade Balance With World
	Millions Of $ US	%	Millions Of $ US	%		
New Zealand	235.8	44.2	172.3	69.2	+63.5	+86.8
Australia	298.8	23.5	1277.8	103.0	-979.0	-808.7
Canada	1978.6	29.3	1561.2	22.4	+417.4	+537.1
Japan	2894.8	72.3	1191.8	28.7	+1703.0	+1828.9
United States	3329.4	32.1	4534.4	43.5	-1205.0	-854.9
Total	8737.4	38.0	8737.5	38.0	0	+789.3

(B) By Major Commodity Division

Commodity Division	Millions Of $ US	%
Crude Foodstuffs	264.1	18.6
Processed Foodstuffs	489.4	46.8
Crude Materials	166.7	4.8
Semi-Manufactures	475.0	16.9
Finished Manufactures and Chemicals	7342.2	51.4
Total	8737.4	38.0

TABLE 7 (concluded)

TOTAL TRADE CREATION AND TRADE DIVERSION EFFECTS OF PAFTA

(II) Elasticity of Substitution = 2 and Based Upon High Import Demand Elasticities

(A) By Country

Country	Increase In Exports Of PAFTA		Increase In Imports Of PAFTA		Net Change In Trade Balance With PAFTA	Net Change In Trade Balance With World
	Millions Of $ US	%	Millions Of $ US	%		
New Zealand	261.4	49.0	197.1	79.4	+64.3	+112.4
Australia	343.1	27.1	1461.5	117.8	-1118.4	-764.4
Canada	2141.9	31.7	1675.1	24.1	+466.8	+700.4
Japan	3146.1	76.6	1314.4	31.7	+1831.7	+2080.2
United States	3648.9	35.2	4893.2	46.9	-1244.3	-535.4
Total	9541.4	41.4	9541.4	41.4	0	+1593.2

(B) By Major Commodity Division

Commodity Division	Millions of $ US	%
Crude Foodstuffs	329.6	23.2
Processed Foodstuffs	536.7	51.3
Crude Materials	220.8	5.8
Semi-Manufactures	537.2	19.1
Finished Manufactures and Chemicals	7916.8	55.3
TOTAL	9541.1	41.4

77% for high elasticities or about 50% and 28% for the medium and low elasticities respectively. Australia has the least export gain, it being only about 25% even if the high elasticities were applicable. And as seen before, finished manufactures and chemicals are the most important source of increased trade.

It is of some interest to compare the changes in exports, imports and net trade balance with the GNP of the five countries. This is done in Table 8. The most striking thing to observe is that the rise in Australian imports from PAFTA, if based on the high elasticities, could amount to 5.6% of GNP,[30] and the net deterioration in its trade balance with the world could be as high as 3.6% of GNP. Although the U.S. would experience a somewhat greater absolute deterioration in its trade balance with the world, the change, relative to its GNP would be only .1% at a maximum.

IV. OTHER CONSIDERATION

A number of other factors, both static and dynamic, would alter the outcome of any free trade area from that shown above. Most of these have been discussed more thoroughly elaswhere[31] than there is space to do here, and to attempt assigning quantitative values to them is of questionable worth. But it may be useful to summarize the more important of them with particular reference to their impact on the individual PAFTA nations.

Consider Japan first. The freeing of trade as conceived of so far in this paper suggests a sizeable benefit to the Japanese balance of trade. On the one hand, the benefit might be greater if some allowance were made for the reduction in pre-PAFTA trade diversion stemming from the British preferential system and for the elimination of import quotas, actual or defacto, by the United States, Canada and New Zealand on Japanese products. On the other hand, preferences extended to the less developed nations

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30 The rise in Australian net imports (i.e. excluding reductions in imports from the rest-of-the-world due to trade diversion effects) would be 4.9% of GNP.

31 See the papers from the First Conference on Pacific Trade and Development, especially those by Cooper, Drysdale, McDougall, Kojima and Wilkinson. See also the Atlantic Trade Study series and Balassa, Trade Liberalization Among Industrial Countries, Chapter V.

TABLE 8

TOTAL INCREASE IN EXPORTS AND IMPORTS[1]
FROM A PACIFIC AREA FREE TRADE AGREEMENT
AS PERCENTAGE OF GROSS NATIONAL PRODUCTS 1966

	Percentages of GNP		
	Exports	Imports	Net Improvement in Trade Balance with World[3]
New Zealand	2.2	1.6	+ .8
Australia	1.3	5.6	-3.6
Canada	3.7	2.9	+1.0
Japan	3.0	1.2	+1.9
United States	.4	.6	- .1

1 Based on high import demand elasticities and elasticity of substitution of unity.

2 These are based on increases in imports from PAFTA and therefore include the trade diversion effects.

3 These are based on the expansions in exports less the net rises in imports from the total world. That is, those increases in imports from PAFTA which are offset by reduced imports from the rest-of-the-world are excluded in arriving at these percentages.

within the Pacific area by the developed PAFTA nations would probably be more to Japan's disadvantage than to the other developed nations. Like the other PAFTA developed countries, she would face increased imports of mostly labour intensive manufactures which would be offset by increased exports to the LDC's only to the extent that they spent their increased foreign exchange receipts on her products. But in addition, Japan would also face reduced exports of her own labour intensive products to the other PAFTA nations. It is difficult to say what the net effect of these diverse influences might be. But they would be unlikely to reduce very substantially the favourable Japanese position resulting from PAFTA. It is not difficult to understand the Japanese interest in a Pacific Area Free Trade Agreement.

In view of the benefit that Japan stands to reap it seems unreasonable for them to refuse to touch their domestic agriculture, and still expect Australia and New Zealand to be enthusiastic participants in a free trade proposal.

Suppose, for a moment, that over the time period in which tariffs were to be eliminated in PAFTA Japan did reduce agricultural subsidies and permitted increased agricultural imports of $US. 1 billion (more than sufficient to offset any Australian deficit). Given an average income of about $US 400 per year for agricultural workers in Japan, these expanded imports would displace 2-1/2 million workers or about 5% of the Japanese labour force. This displacement is not unduly large considering the extent of the removal of farm workers into the industrial labour force over recent years. Moreover it would still leave a larger proportion of the Japanese labour force in agriculture than in any other developed nation.

The advantages to the Japanese from this easing of agricultural import restrictions include higher average income per head through workers having higher productivity in manufacturing than in agriculture, increased farm productivity through having more efficient sized units and more mechanization, and lower food prices resulting from the improved farm productivity and availability of cheaper imported foodstuffs. Indeed, if Japan is not to suffer greater inflationary pressures and sharply rising export supply prices stemming from her stronger trade balance in PAFTA, releasing of more agricultural workers for manufacturing and keeping food prices down through cheaper imports and higher domestic farm productivity may be the only answer.

Notice too that the arguments for lower Japanese agricultural protection are very similar to those which will have to be used by the governments of New Zealand and Australia if they are to sell free trade to their respective manufacturers: there are economies of scale and lower prices to be reaped by the alert and more capable of them. The main difference is that the manufacturing sectors in New Zealand and Australia that must be convinced of this argument involve a larger share of each nation's labour force than does the agricultural sector in Japan.

In general, I would digress to suggest that politicians, and economists too, tend to overestimate the political strength and importance of the "preserve-the-agricultural-community-at-all consts" argument. This in turn stems from an underestimate of the economic rationality of farmers. Certainly, for example, in the important grain-growing areas of Western Canada the farmers themselves realize that it is only the efficient, large-acreage farmer that is going to survive and that those who do not adjust to changing conditions will not. They, and their offspring and brothers who have migrated to the cities, are often more incensed by the abuses that they must face as consumers than the adjustments that must be made on the farms to altered circumstances there.

The foregoing comments regarding Japan are also relevant to some extent to the United States. She too would benefit somewhat from the removal of the British preferential system insofar as it affected trade among Australia, New Zealand, and Canada and between these countries and the United Kingdom. She would also experience some adverse effect upon her trade balance by the extension of preferences to the LDC's. And her imports would increase to the extent that quotas on Japanese products and agricultural protectionism in all its forms were eliminated. Her trade balance might worsen slightly if these factors were allowed for quantitatively. Only if there were reduced capital outflows would she avoid adding to her present balance of payments difficulties. While some reduction of capital outflows might occur vis-a-vis Canada, outflows to Japan and possibly Australia or New Zealand would undoubtedly expand; so little net gain could be expected from this source. The domestic adjustment required by the adverse trade balance resulting from PAFTA, relative to total production, is of course pretty insignificant. Internationally, a worsened trade picture by several hundred millions, while small in relative terms, would be viewed with more apprehension. Hence no free trade agreement promising such results is likely to be greeted with much zeal by the U.S. authorities. They are likely to have interest only in some larger agreement consisting of their other important markets-- EFTA and/or the EEC.[32]

Australia and New Zealand would be the main beneficiaries of the reduction in agricultural protectionism in Japan and the United States. Also, New Zealand would benefit by lowered government assistance to the Australian dairy industry. If the devaluation has not been sufficient, she might in turn find her manufacturing facing important new challenges from the removal of the present import quotas as well as tariffs. But presumably her citizens, and those of Australia too, will be better off, both as consumers and as producers, from the spur to improved productivity that would come through the elimination of protected markets at home. A shakedown in management and economies of scale could hopefully be realized. More aggressive selling abroad will also be necessary, however, not only for manufactures but also for agricultural goods.[33]

Canada's position appears unequivocally better than under any previous estimates of PAFTA, primarily because of the interpretation given to trade creation effects in this paper. But the improved trade balance may be reduced a little as preferences are extended to the LDC's in PAFTA and de facto quotas on imports from Japan and Hong Kong are eliminated. Also her full balance of payments position may not be as favourable as intimated by pure trade effects. She probably will face some reduction in capital inflows from the United States as free trade permits servicing of the Canadian market from U.S. plants.

A final comment is necessary regarding the new dynamic theories of trade in relation to the impact of any free trade proposal for the Pacific area. In addition to the possibility of achieving economies of scale in production, there are other economies often important in the location of production and hence in the direction of trade flows. Where research and development into new products and processes is a vital source of trade advantage, such

32 This is subject to the qualification in the final paragraph of this paper.

33 To illustrate, of the 150 pounds of meats consumed per capita in Canada in 1967, only 3 pounds were lamb and mutton. In fact, it is only on rare occasions that one can buy lamb or mutton in the stores, and then it is generally of very low quality.

work frequently can be undertaken only by the most financially powerful firms--frequently American owned. Production will generally take place, at least initially, in the large home market areas where there is an abundance of specialized services.[34] Even if in the course of a product cycle low wage trade were to replace technological gap trade, New Zealand, Australia and Canada likely would not be the new production locations. Rather, Japan or a less developed nation would be favoured. Also, regardless of which country innovates or which one has slightly favourable production cost advantages, the pull of the large concentrated markets may often be the deciding factor in production location. There are advantages to locating production near the centres where purchases are greatest both so that quick overnight deliveries are possible and so that follow-up consulting or repair services may be rendered easily. These dynamic considerations then, would tend to make the U.S. position, and possibly the Japanese one too, more favourable in the event of free trade than the above static computations suggest. The benefits to New Zealand, Australia and Canada might accordingly be reduced.

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34 The important reference on these ideas is R. Vernon, "International Investment and International Trade in the Product Cycle", Quarterly Journal of Economics, Vol. LXXX (May, 1966) pp. 190-207.

APPENDIX A

STANDARD INTERNATIONAL TRADE CLASSIFICATION COMMODITY DIVISIONS, GROUPS AND SUBGROUPS DISTINGUISHED

1) Crude Foodstuffs and Feed:

   00, 04, 05, 06, 07, 08, 09, 121.

2) Processed Foodstuffs and Feed:

   01, 02, 03, 111, 112, 122.

3) Crude Materials:

   21, 22, 231.1, 231.3, 231.4, 241, 244, 26, 27, 28, 29, 32, 331, 34, 35, 41.

4) Semi-Manufactures (non-food):

   242, 243, 251, 42, 43, 61, 62, 631-633, 661-664, 671 672, 681-689.

5) Finished-Manufactures and Chemicals:

   231.2, 332, 51-59, 641.1, 641.2-641.9, 642, 651-657, 665-667, 673-679, 691-698, 711-899.

APPENDIX TABLE A-1

SUMMARY OF TRADE BY PAFTA COUNTRIES, 1966

(Millions of $ US)

Importers / Exporters	New Zealand	Australia	Canada	Japan	USA	Total PAFTA	Deficit(-) or Surplus(+) on Trade with PAFTA
New Zealand		48	13	113	179	353	-76
Australia	191		54	677	386	1308	+79
Canada	47	111		450	5794	6401	-233
Japan	65	289	228		2916	3498	-392
United States	126	782	6339	2650		9896	+621
Total PAFTA	428	1229	6634	3890	9274	21456	

Source: Imports of countries from U.N. Statistical Papers Series D, Vol. XVI, Nos. 1-22, 1-24, 1-28, 1-29, 1-30.

APPENDIX TABLE A-2

COMPOSITION OF PAFTA COUNTRIES EXPORTS TO PAFTA BY COMMODITY DIVISIONS IN 1966

(Percentages)

Exporting Country	Commodity Divisions 1	2	3	4	5	Total
New Zealand	2.6	33.6	44.5	7.4	11.9	100.0
Australia	10.4	19.4	49.3	5.5	15.4	100.0
Canada	4.5	5.2	18.9	24.4	47.0	100.0
Japan	0.9	3.1	1.6	6.7	87.7	100.0
USA	9.5	0.8	13.9	7.7	68.1	100.0

Source: Based on imports for PAFTA countries, UN Statistical Papers, Series D, Vol. XVI, No. 1-22, 1-14, 1-28, 1-29, 1-30.

APPENDIX TABLE A-3

COMPOSITION OF PAFTA COUNTRIES IMPORTS FROM PAFTA BY COMMODITY DIVISIONS IN 1966

(Percentages)

Importing Country	Commodity Divisions 1	2	3	4	5	Total
New Zealand	5.8	0.5	7.2	9.6	76.9	100.0
Australia	2.4	1.3	4.4	6.6	85.3	100.0
Canada	5.1	1.2	7.5	6.3	79.9	100.0
Japan	20.5	2.6	41.5	11.5	23.9	100.0
USA	2.3	7.5	13.5	17.9	58.8	100.0

Source: Based on imports for PAFTA countries, UN Statistical Papers, Series D. Vol. XVI, Nos. 1-22, 1-24, 1-28, 1-29, 1-30.

APPENDIX TABLE A-4

SHARES OF IMPORTS OF EACH PAFTA COUNTRY COMING FROM THE OTHER PAFTA COUNTRIES, BY COMMODITY DIVISION, AFTER USING ADJUSTMENT FOR THE KENNEDY ROUND AND NEW ZEALAND DEVALUATIONS, USING MEDIUM ELASTICITIES[1] FOR 1966

Importing Country	Division	Source of Imports: New Zealand	Australia	Canada	Japan	United States	Total PAFTA
New Zealand	1		75.0	0	0	25.0	100.0
	2		13.9	58.8	22.8	4.4	100.0
	3		28.4	17.7	4.2	49.7	100.0
	4		54.2	28.0	2.1	15.6	100.0
	5		42.6	8.6	18.9	29.9	100.0
AVERAGE			44.9	11.3	14.1	29.6	100.0
Australia	1	14.5		2.5	3.5	79.5	100.0
	2	12.3		16.8	50.4	20.5	100.0
	3	8.7		28.4	9.7	53.2	100.0
	4	11.1		23.3	24.0	41.5	100.0
	5	2.7		6.8	24.7	65.8	100.0
AVERAGE		4.0		8.9	23.8	63.3	100.0
Canada	1	0.0	5.7		1.1	93.2	100.0
	2	5.0	20.2		6.3	68.5	100.0
	3	1.8	2.1		.4	95.7	100.0
	4	.0	.2		3.8	96.0	100.0
	5	.0	.0		3.9	96.0	100.0
AVERAGE		.2	.8		3.4	95.5	100.0
Japan	1	.2	9.0	15.9		74.9	100.0
	2	35.9	35.5	5.5		23.1	100.0
	3	2.8	32.7	11.3		53.3	100.0
	4	3.6	4.6	21.1		70.6	100.0
	5	1.1	2.4	4.1		92.4	100.0
AVERAGE		2.8	16.9	11.3		69.0	100.0
United States	1	.7	12.3	75.0	12.1		100.0
	2	13.7	27.4	46.4	12.4		100.0
	3	6.3	8.2	81.6	3.9		100.0
	4	.0	1.8	85.7	12.5		100.0
	5	1.5	.6	49.8	48.1		100.0
AVERAGE		2.7	4.0	60.2	33.1		100.0

Notes: [1]Percentages are roughly similar before adjustment for Kennedy Round and New Zealand devaluations.

APPENDIX TABLE A-5

FIRST APPROXIMATION TO STATIC TRADE-CREATION EFFECTS OF PAFTA, IN VALUE TERMS

(millions of $ US)

(A) HIGH ELASTICITIES

		New Zealand	Australia	Canada	Japan	United States	PAFTA
New Zealand	X		4.0	.3	24.6	96.8	125.7
	M		16.9	3.8	15.2	25.3	61.2
	X-M		-12.9	-3.5	+9.4	+71.5	+64.5
Australia	X	16.9		2.9	41.2	63.1	124.1
	M	4.0		22.4	160.3	392.5	579.2
	X-M	+12.9		-19.5	-119.1	-329.4	-455.1
Canada	X	3.8	22.4		34.6	574.0	634.8
	M	.3	2.9		75.1	1109.0	1187.3
	X-M	+3.5	+19.5		-40.5	-535.0	-552.5
Japan	X	15.2	160.3	75.1		1363.5	1614.1
	M	24.6	41.2	34.6		489.4	589.8
	X-M	-9.4	+119.1	+40.5		+874.1	+1024.3
United States	X	25.3	392.5	1109.0	489.4		2016.2
	M	96.8	63.1	574.0	1363.5		2097.4
	X-M	-71.5	+329.4	+535.0	-874.1		-81.2
PAFTA	X						4515.0

(B) MEDIUM ELASTICITIES

		New Zealand	Australia	Canada	Japan	United States	PAFTA
New Zealand	X		2.2	.2	11.0	45.5	58.9
	M		14.5	3.2	13.5	21.9	53.1
	X-M		-12.3	-3.0	-2.5	+23.6	+5.8
Australia	X	14.5		1.6	21.6	34.8	72.5
	M	2.2		14.7	105.8	258.9	381.6
	X-M	+12.3		-13.1	-84.2	-224.1	-309.1
Canada	X	3.2	14.7		19.5	340.4	377.8
	M	.2	1.6		48.4	706.2	756.4
	X-M	+3.0	+13.1		-28.9	-365.4	-378.6
Japan	X	13.5	105.8	48.4		836.4	1004.1
	M	11.0	21.6	19.5		293.8	345.9
	X-M	+2.5	+84.2	+28.9		+542.6	+658.2
United States	X	21.9	258.9	706.2	293.8		1280.8
	M	45.5	34.8	340.4	836.4		1257.1
	X-M	-23.6	+224.1	+365.4	-542.6		+23.7
PAFTA							2795.0

(C) LOW ELASTICITIES

		New Zealand	Australia	Canada	Japan	United States	PAFTA
New Zealand	X		1.0	.1	4.7	16.9	22.7
	M		9.0	2.0	8.4	13.6	33.0
	X-M		-8.0	-1.9	-3.7	+3.3	-10.3
Australia	X	9.0		.8	10.6	17.1	37.5
	M	1.0		7.4	52.2	130.3	190.9
	X-M	+8.0		-6.6	-41.6	-113.2	-153.4
Canada	X	2.0	7.4		9.6	160.9	179.9
	M	.1	.8		23.7	345.8	370.4
	X-M	+1.9	+6.6		-14.1	-184.9	-190.5
Japan	X	8.4	52.2	23.7		387.6	471.9
	M	4.7	10.6	9.6		139.3	164.2
	X-M	+3.7	+41.6	+14.1			+307.7
United States	X	13.6	130.3	345.8	139.3		629.0
	M	16.9	17.1	160.9	387.6		582.5
	X-M	-3.3	+113.2	+184.9	-248.3		+46.5
PAFTA							1340.0

APPENDIX TABLE A-6

TOTAL STATIC TRADE CREATION EFFECTS OF PAFTA, IN PERCENTAGE RATES OF INCREASE BASED ON ADJUSTED[1] 1966 TRADE

(A) HIGH ELASTICITIES

		New Zealand	Australia	Canada	Japan	United States	PAFTA
New Zealand	X		38.4	6.7	34.2	43.2	40.0
	M		48.1	46.2	94.3	68.4	60.1
Australia	X	48.1		9.4	10.9	29.7	20.3
	M	38.4		56.7	99.3	93.6	89.3
Canada	X	46.2	56.7		14.9	27.2	26.9
	M	6.7	9.4		34.5	20.3	20.7
Japan	X	94.3	99.3	34.5		63.5	64.6
	M	34.2	10.9	14.9		30.6	25.7
United States	X	68.4	93.6	20.3	30.6		29.0
	M	43.2	29.7	27.2	63.5		40.1
PAFTA							34.5

(B) MEDIUM ELASTICITIES

		New Zealand	Australia	Canada	Japan	United States	PAFTA
New Zealand	X		25.8	3.8	19.3	27.0	24.2
	M		30.3	28.4	58.1	44.5	38.2
Australia	X	30.3		5.0	5.8	16.2	11.7
	M	25.8		35.8	64.0	60.4	57.7
Canada	X	28.4	35.8		8.5	16.4	16.3
	M	3.8	5.0		22.8	13.2	13.4
Japan	X	58.1	64.0	22.8		41.4	42.1
	M	19.3	5.8	8.5		18.7	15.4
United States	X	44.5	60.4	13.2	18.7		18.6
	M	27.0	16.2	16.4	41.4		25.0
PAFTA							21.5

(C) LOW ELASTICITIES

		New Zealand	Australia	Canada	Japan	United States	PAFTA
New Zealand	X		13.7	1.5	8.9	13.2	11.7
	M		14.8	14.2	28.0	22.2	18.9
Australia	X	14.8		2.4	2.8	7.9	6.2
	M	13.7		17.6	31.2	29.8	28.5
Canada	X	14.2	17.6		4.1	7.8	7.7
	M	1.5	2.4		11.4	6.5	6.7
Japan	X	28.0	31.2	11.4		20.4	20.8
	M	8.9	2.8	4.1		8.9	7.3
United States	X	22.2	29.8	6.5	8.9		9.2
	M	13.2	7.9	7.8	20.4		12.0
PAFTA							10.5

Notes: 1. Adjusted for Kennedy Round and New Zealand Devaluation.

APPENDIX TABLE A-7

TOTAL STATIC TRADE CREATION EFFECTS OF PAFTA, BY COUNTRY

(Millions of $ US)

(A) HIGH ELASTICITIES

		New Zealand	Australia	Canada	Japan	United States	PAFTA
New Zealand	X		21.0	.9	44.9	144.2	211.0
	M		53.9	13.4	31.2	50.5	149.0
	X-M		-32.9	-12.5	+13.7	+93.7	+62.0
Australia	X	53.9		5.1	75.3	122.2	256.5
	M	21.0		62.4	292.4	731.7	1107.5
	X-M	+32.9		-57.3	-217.1	-609.5	-851.0
Canada	X	13.4	62.4		68.7	1673.0	1817.5
	M	.9	5.1		84.9	1350.6	1441.5
	X-M	+12.5	+57.3		-16.2	+322.4	+376.0
Japan	X	31.2	292.4	84.9		2244.9	2653.4
	M	44.9	75.3	68.7		877.0	1065.9
	X-M	-13.7	+217.1	+16.2		+1367.9	+1587.5
United States	X	50.5	731.7	1350.6	877.0		3009.8
	M	144.2	122.2	1673.0	2244.9		4184.3
	X-M	-93.7	+609.5	-322.4	-1367.9		-1174.5
PAFTA							7948.0

(B) MEDIUM ELASTICITIES

		New Zealand	Australia	Canada	Japan	United States	PAFTA
New Zealand	X		12.6	.5	21.8	71.7	106.6
	M		42.2	10.0	25.5	40.9	118.5
	X-M		-29.6	-9.5	-3.7	+30.8	-11.9
Australia	X	42.2		2.7	39.3	64.9	149.1
	M	12.6		39.3	188.4	472.4	712.7
	X-M	+29.6		-36.6	-149.1	-407.5	-563.6
Canada	X	10.0	39.3		38.8	989.8	1077.9
	M	.5	2.7		54.6	859.7	917.5
	X-M	+9.5	+36.6		-15.8	+130.1	+160.4
Japan	X	25.5	188.4	54.6		1368.0	1636.5
	M	21.8	39.3	38.8		521.0	620.9
	X-M	+3.7	+149.1	+15.8		+847.0	+1015.6
United States	X	40.9	472.4	859.7	521.0		1894.0
	M	71.7	64.9	989.8	1368.0		2494.5
	X-M	-30.8	+407.5	-130.1	-847.0		-600.5
PAFTA							4864.1

(C) LOW ELASTICITIES

		New Zealand	Australia	Canada	Japan	United States	PAFTA
New Zealand	X		6.0	.2	9.1	29.0	44.3
	M		24.5	5.8	15.2	24.2	69.8
	X-M		-18.5	-5.6	-6.1	+4.8	-25.5
Australia	X	24.5		1.3	19.1	31.2	76.1
	M	6.0		19.3	91.9	232.8	350.0
	X-M	+18.5		-18.0	-72.8	-201.6	-273.9
Canada	X	5.8	19.3		18.8	460.0	503.9
	M	.2	1.3		26.7	420.8	449.0
	X-M	+5.6	+18.0		-7.9	+39.2	+54.9
Japan	X	15.2	91.9	26.7		630.6	764.4
	M	9.1	19.1	18.8		243.3	290.3
	X-M	+6.1	+72.8	+7.9		+387.3	+474.1
United States	X	24.2	232.8	420.8	243.3		921.1
	M	29.0	31.2	460.0	630.6		1150.8
	X-M	-4.8	+201.6	-39.2	-387.3		-229.7
PAFTA							2309.8

APPENDIX TABLE A-8

TOTAL STATIC TRADE CREATION EFFECTS OF PAFTA BY MAJOR COMMODITY GROUPS, IN US DOLLARS AND AS PERCENTAGES OF PRE-PAFTA TRADE FLOWS

High Import Demand Elasticities

		Foodstuffs		Processed Foodstuffs		Crude Materials		Semi-Manufactures		Finished Manu. & Chemicals	
		$	%	$	%	$	%	$	%	$	%
New Zealand	X	1.0	12.2	80.1	45.3	6.6	4.5	4.0	13.2	118.8	69.5
	M	3.0	13.0	3.7	246.7	.7	2.4	5.1	15.7	136.5	84.2
	X-M	-2.0		+76.4		+5.9		-1.1		-17.7	
Australia	X	19.1	14.1	109.6	40.4	20.9	3.2	16.4	22.7	90.4	66.1
	M	6.0	21.0	17.8	108.5	6.5	12.2	24.4	28.6	1052.5	99.5
	X-M	+13.1		+91.8		+14.4		-8.0		-962.3	
Canada	X	58.9	20.3	158.6	41.1	53.4	4.4	231.8	14.1	1314.8	40.9
	M	10.3	3.0	16.9	19.7	1.4	.3	35.3	8.1	1367.9	24.5
	X-M	+48.6		+141.7		+52.0		+196.5		-53.1	
Japan	X	7.6	25.0	55.5	44.3	3.8	6.6	56.2	21.4	2530.3	69.7
	M	118.4	14.7	87.6	75.7	45.4	2.8	77.7	16.0	737.7	66.0
	X-M	110.8		-32.1		-41.6		-21.5		+1792.6	
United States	X	107.8	11.3	39.3	44.9	28.9	2.1	106.4	14.0	2727.4	38.2
	M	57.2	17.4	317.4	38.4	59.7	4.8	262.6	16.4	3487.9	54.8
	X-M	+50.6		-278.1		-30.6		-156.4		-760.0	
PAFTA		194.5	13.7	443.0	42.4	113.5	3.3	414.8	14.9	6781.5	47.4

APPENDIX TABLE A-9

TRADE DIVERSION EFFECTS OF PAFTA BY COUNTRY
(millions of $ US)

(I) Elasticity of Substitution = 1

(A) High Import Demand Elasticities

		New Zealand	Australia	Canada	Japan	United States	PAFTA
New Zealand	X		3.3	.1	2.8	18.6	24.8
	M		9.4	2.0	4.2	7.7	23.3
	X-M		-6.1	-1.9	-1.4	+10.9	+1.5
Australia	X	9.4		1.1	16.2	15.6	42.3
	M	3.3		12.0	46.1	108.9	170.3
	X-M	+6.1		-10.9	-29.9	-93.3	-128.0
Canada	X	2.0	12.0		11.7	135.4	161.1
	M	.1	1.1		10.6	107.8	119.7
	X-M	+1.9	+10.9		+1.1	+27.6	+41.4
Japan	X	4.2	46.1	10.6		180.5	241.4
	M	2.8	16.2	11.7		95.2	125.9
	X-M	+1.4	+29.9	-1.1		+85.3	+115.5
United States	X	7.7	108.9	107.8	95.2		319.6
	M	18.6	15.6	135.4	180.5		350.1
	X-M	-10.9	+93.3	-27.6	-85.3		-30.5
PAFTA							789.3

(B) Medium Import Demand Elasticities

		New Zealand	Australia	Canada	Japan	United States	PAFTA
New Zealand	X		3.0	.1	2.4	15.1	20.6
	M		11.3	2.4	5.2	9.3	28.3
	X-M		-8.3	-2.3	-2.8	+5.8	-7.7
Australia	X	11.3		1.1	16.1	15.4	43.9
	M	3.0		11.7	44.9	105.9	165.5
	X-M	+8.3		-10.6	-28.8	-90.5	-121.6
Canada	X	2.4	11.7		11.6	128.0	153.7
	M	.1	1.1		10.3	103.9	115.4
	X-M	+2.3	+10.6		+1.3	+24.1	+38.3
Japan	X	5.2	44.9	10.3		165.8	226.2
	M	2.4	16.1	11.6		91.4	121.5
	X-M	+2.8	+28.8	-1.3		+74.4	+104.7
United States	X	9.3	105.9	103.9	91.4		310.5
	M	15.1	15.4	128.0	165.8		324.3
	X-M	-5.8	+90.5	-24.1	-74.4		-13.8
PAFTA							754.9

(C) Low Import Demand Elasticities

		New Zealand	Australia	Canada	Japan	United States	PAFTA
New Zealand	X		2.8	.1	2.1	12.4	17.4
	M		13.1	2.7	6.2	10.8	32.7
	X-M		-10.3	-2.6	-4.1	+1.6	-15.3
Australia	X	13.1		1.1	16.0	15.3	45.5
	M	2.8		11.4	43.7	102.8	160.6
	X-M	+10.3		-10.3	-27.7	-87.5	-115.1
Canada	X	2.7	11.4		11.5	121.3	146.9
	M	.1	1.1		9.9	100.2	111.3
	X-M	+2.6	+10.3		+1.6	+21.1	+35.6
Japan	X	6.2	43.7	9.9		151.7	211.5
	M	2.1	16.0	11.5		87.9	117.5
	X-M	+4.1	+27.7	-1.6		+63.8	+94.0
United States	X	10.8	102.8	100.2	87.9		301.7
	M	12.4	15.3	121.3	151.7		300.7
	X-M	-1.6	+87.5	-21.1	-63.8		+1.0
PAFTA							723.0

APPENDIX TABLE A-9 (continued)

(II) Elasticity of Substitution = 2

(A) High Import Demand Elasticities

		New Zealand	Australia	Canada	Japan	United States	PAFTA
New Zealand	X		6.9	.2	5.5	37.8	50.4
	M		19.4	4.1	8.8	15.8	48.1
	X-M		-12.5	-3.9	-3.3	+22.0	+2.3
Australia	X	19.4		2.3	33.5	31.4	86.6
	M	6.9		24.8	95.4	226.9	354.0
	X-M	+12.5		-22.5	-61.9	-195.5	-267.4
Canada	X	4.1	24.8		23.1	272.4	324.4
	M	.2	2.3		21.2	210.0	233.6
	X-M	+3.9	+22.5		+1.9	+62.4	+90.8
Japan	X	8.8	95.4	21.2		367.3	492.7
	M	5.5	33.5	23.1		186.4	248.5
	X-M	+3.3	+61.9	-1.9		+180.9	+244.2
United States	X	15.8	226.9	210.0	186.4		639.1
	M	37.8	31.4	272.4	367.3		708.9
	X-M	-22.0	+195.5	-62.4	-180.9		-69.8
PAFTA							1593.0

(B) Medium Import Demand Elasticities

		New Zealand	Australia	Canada	Japan	United States	PAFTA
New Zealand	X		6.2	.2	4.7	30.9	42.0
	M		23.3	4.8	11.0	19.0	58.0
	X-M		-17.1	-4.6	-6.3	+11.9	-16.0
Australia	X	23.3		2.3	33.3	31.1	90.0
	M	6.2		24.1	92.6	219.8	342.7
	X-M	+17.1		-21.8	-59.3	-188.7	-252.7
Canada	X	4.8	24.1		22.8	257.6	309.3
	M	.2	2.3		20.5	202.2	225.2
	X-M	+4.6	+21.8		+2.3	+55.4	+84.1
Japan	X	11.0	92.6	20.5		337.2	461.3
	M	4.7	33.3	22.8		178.8	239.6
	X-M	+6.3	+59.3	-2.3		+158.4	+221.7
United States	X	19.0	219.8	202.2	178.8		619.8
	M	30.9	31.1	257.6	337.2		656.8
	X-M	-11.9	+188.7	-55.4	+158.4		-37.0
PAFTA							1522.4

(C) Low Import Demand Elasticities

		New Zealand	Australia	Canada	Japan	United States	PAFTA
New Zealand	X		5.7	.2	4.2	25.4	35.3
	M		26.7	5.4	12.9	21.9	66.9
	X-M		-21.0	-5.2	-8.7	+3.5	-31.6
Australia	X	26.7		2.3	33.2	31.0	93.2
	M	5.7		23.3	89.7	212.4	331.1
	X-M	+21.0		-21.0	-56.5	-181.4	-237.9
Canada	X	5.4	23.3		22.6	244.6	295.9
	M	.2	2.3		19.8	195.0	217.3
	X-M	+5.2	+21.0		+2.8	+49.6	+78.6
Japan	X	12.9	89.7	19.8		308.5	430.9
	M	4.2	33.2	22.6		171.6	231.6
	X-M	+8.7	+56.5	-2.8		+136.9	+199.3
United States	X	21.9	212.4	195.0	171.6		600.9
	M	25.4	31.0	244.6	308.5		609.4
	X-M	-3.5	+181.4	-49.6	-136.9		-8.5
PAFTA							1456.3

APPENDIX TABLE A-10

SUMMARY OF TRADE DIVERSION EFFECTS OF PAFTA

(I) Elasticity of Substitutes = 1

Import Demand Elasticities	N.ZEALAND X	M^1	AUSTRALIA X^2	M	CANADA X	M	JAPAN X	M	USA X	M	PAFTA X
A.High	24.8	23.3	42.3	170.3	161.1	119.7	241.4	125.9	319.6	350.1	789.3
B.Medium	20.6	28.7	43.9	165.5	153.7	115.4	226.2	121.5	310.5	324.3	754.9
C.Low	17.4	32.7	45.5	160.6	146.9	111.3	211.5	117.5	301.7	300.7	723.0

(II) Elasticity of Substitution = 2

Import Demand Elasticities	N.ZEALAND X	M^1	AUSTRALIA X^2	M	CANADA X	M	JAPAN X	M	USA X	M	PAFTA X
A.High	50.4	48.1	86.6	354.0	324.4	233.6	492.7	248.5	639.1	708.9	1593.1
B.Medium	42.0	58.0	90.0	342.7	309.3	225.2	461.3	239.6	619.8	656.8	1522.4
C.Low	35.3	66.9	93.2	331.1	295.9	217.3	430.9	231.6	600.9	609.4	1456.3

Notes: 1. Trade diversion effects are greater when the medium and low import demand elasticities are used because with these elasticities the impact of the New Zealand devaluation on that country's imports is less and hence the trade diversion computed using the formula in Appendix B is less.

2. Trade diversion effects are greater for the medium and low import demand elasticities because with these elasticities Australian exports to New Zealand are reduced less owing to the New Zealand devaluation than they are under the higher elasticity. The impact is sufficiently great that when carried through all the computations it produces the results indicated above.

APPENDIX TABLE A-11

TRADE DIVERSION EFFECTS OF PAFTA BY COMMODITY GROUPS

(Millions of $ US)

(1) Elasticity of substitution = 1 and High Import Demand Elasticities

Country		Crude Foodstuffs	Processed Foodstuffs	Crude Materials	Semi-Manufactures	Finished Manufactures & Chemicals	Total
New Zealand	X	.9	7.0	4.0	.8	12.0	24.8
	M	2.2	.3	.8	1.8	18.2	23.3
	X-M	-1.3	+6.7	+3.2	-1.0	-6.2	+1.5
Australia	X	11.7	8.4	7.5	4.6	9.9	42.1
	M	3.5	3.1	3.3	8.6	151.8	170.3
	X-M	+8.2	+5.3	+4.2	-4.0	-141.9	-128.2
Canada	X	11.1	18.3	26.1	26.8	78.8	161.1
	M	5.3	1.8	.9	5.8	105.9	119.7
	X-M	+5.8	+16.5	+25.2	+21.0	-27.1	+41.4
Japan	X	2.5	6.0	2.3	12.2	218.0	241.0
	M	48.3	7.1	17.8	9.7	43.0	125.9
	X-M	-45.8	-1.1	-15.5	+2.5	+175.0	+115.1
United States	X	43.4	6.7	13.3	15.8	240.9	320.1
	M	10.3	33.8	30.6	34.8	240.7	350.1
	X-M	+33.1	-27.1	-17.3	-19.0	+.2	-30.0
PAFTA	X	69.6	46.4	53.2	60.2	559.6	789.1

(2) Elasticity of Substitution = 2 and High Import Demand Elasticities

Country		Crude Foodstuffs	Processed Foodstuffs	Crude Materials	Semi-Manufactures	Finished Manufactures & Chemicals	Total
New Zealand	X	1.9	14.1	8.1	1.8	24.6	50.5
	M	4.2	.7	1.7	3.5	37.9	48.1
	X-M	-2.3	+13.4	+6.4	-1.7	-13.3	+2.4
Australia	X	24.7	17.1	15.1	9.4	20.3	86.6
	M	6.8	6.7	6.6	17.7	316.1	353.9
	X-M	+17.9	+10.4	+8.5	-8.3	-295.8	-267.3
Canada	X	22.2	36.9	52.7	53.9	158.6	324.3
	M	10.6	3.7	1.7	11.4	206.3	233.6
	X-M	+11.6	+33.2	+51.0	+42.5	-47.7	+90.7
Japan	X	5.3	11.9	4.7	25.5	445.3	492.7
	M	92.3	14.6	35.8	19.7	86.1	248.5
	X-M	-87.0	-2.7	-31.1	+5.8	+359.2	+244.2
United States	X	81.0	13.7	26.7	31.8	485.5	638.7
	M	21.3	68.1	61.6	70.1	487.9	708.9
	X-M	+59.7	-54.4	-34.9	-38.3	-2.4	-70.2
PAFTA	X	135.1	93.7	107.3	122.4	1134.3	1592.8

APPENDIX B

DERIVATION OF FORMULA FOR TRADE DIVERSION EFFECT

To determine the trade diversion represented by any elasticity of substitution the following derivation was used: For any importing country assume a common world price of imports exclusive of the tariff = 1. Thus the pre-PAFTA domestic price of imports from PAFTA countries inclusive of the tariff, or P_P, = 1 + t, where t = the ad valorem tariff. The pre- and post-PAFTA domestic price of imports from the rest-of-the-world inclusive of the tariff, or P_R, also = 1 + t.

Thus
$$d\left(\frac{P_P}{P_R}\right) = \frac{1+t}{1+t} - \frac{1}{1+t}$$

and
$$\frac{P_P}{P_R} = \frac{\frac{1+t}{1+t} + \frac{1}{1+t}}{2}$$

Thus
$$\frac{d\left(\frac{P_P}{P_R}\right)}{\frac{P_P}{P_R}} = \frac{2t}{2+t} \qquad (1)$$

Also, let q_P = quantity and also the value of imports (since $P_P = 1$) of pre-PAFTA imports from PAFTA nations,

q_R = quantity and value of pre-PAFTA imports from non PAFTA nations

and r = the amount by which the quantity of imports from PAFTA increase and from the rest-of-the-world decrease owing to PAFTA.

Thus
$$d\left(\frac{q_P}{q_R}\right) = \frac{q_P + r}{q_R - r} - \frac{q_P}{q_R} = \frac{r(q_R + q_P)}{q_R(q_R - r)}$$

and

$$\frac{q_P}{q_R} = \frac{\frac{q_P + r}{q_R - r} + \frac{q_P}{q_R}}{2} = \frac{2q_Pq_R + r(q_R - q_P)}{2(q_R - r)\,q_R}$$

Thus

$$\frac{d(\frac{q_P}{q_R})}{\frac{q_P}{q_R}} = \frac{2r(q_R + q_P)}{2q_Pq_R + r(q_R - q_P)} \qquad (2)$$

and substituting (1) and (2) into the formula for the elasticity of substitution,

$$e = \frac{\dfrac{d(\frac{q_P}{q_R})}{\frac{q_P}{q_R}}}{\dfrac{d(\frac{P_P}{P_R})}{\frac{P_P}{P_R}}}$$

and solving for r, we obtain

$$r = \frac{2etq_Pq_R}{q_R(2 + t - et) + q_P(2 + t + et)} \qquad (3)$$

or if $e = 1$,

$$r = \frac{tq_Pq_R}{q_R + q_P(1 + t)}$$

Presumably a formula something like this is what H. Cowie and M. Stamp used in their study, The Free Trade Area Option: Opportunity for Britain, The Atlantic Trade Study, (London: Moor House, 1967), although it is not made clear what was done. Certainly it is not valid to use an elasticity of substitution as though it were an import price elasticity as Kreinan appears to do in Alternative Commercial Policies ..., pp. 60-61.

COMMENT ON PROFESSOR WILKINSON'S PAPER BY PROFESSOR McDOUGALL

It is my pleasure to comment on Dr. Wilkinson's paper. I should like to start by complimenting him on the workmanlike way he has set about an arduous research project. He has set out his assumptions clearly and in an admirable manner returns to his assumptions and to their limitations when interpretating his results.

I want to comment briefly on some of these assumptions. In my opinion he has achieved a considerable improvement upon earlier estimates of trade creation and trade diversion by recognizing that the values of the total import demand elasticities used previously understated the values of the elasticities which are relevant to the analysis of tariff changes which occur only within the PAFTA group of countries.

In making allowance for this fact, however, he is forced to make somewhat arbitrary estimates of those imports of a country which as a result of product differentiation would not be available from other countries within the PAFTA group. In the case of these imports the elasticity of supply of the PAFTA countries is assumed to be zero. But he needs also assume that the remaining imports of the country concerned are in perfectly elastic supply in the open PAFTA countries. These are severe assumptions. I am not happy that supply elasticities should be zero for one group of imports and infinitely elastic for all others. There may be some justification for this assumption in the case of the U.S.A. - less so in the case of countries such as Australia and New Zealand. Dr. Wilkinson is, of course, well aware of the limitations these assumptions place upon his analysis.

Import demand elasticities are, of course, best used in computing reactions to small price changes. In this case where the magnitude of the changes in imports and exports is so large I cannot but feel that the result of free trade would be to alter considerably the cost structure, particularly of countries such as Australia and New Zealand. To this extent both the resulting pattern of trade and the magnitude of effects would be modified.

Care also needs be exercised in making use of elasticities derived from U.S.A. experience and in applying these elasticities, which hold for broadly aggregated groups of commodities in the U.S., to the same broadly aggregated but differently weighted groups in other countries. For instance, Dr. Wilkinson gives a range of estimates for the Japanese import demand for crude materials which range between -0.48 -0.1. Yet wool, a crude material, is the major export of both Australia and New Zealand and a number of studies have shown the elasticity of demand for it to be considerably in excess of unity.

Bearing the limitations of these assumptions in mind - and Dr. Wilkinson has performed exceedingly well within the constraints imposed by them - several points can be made.

First, the results in Table 7 indicate that the gains from trade creation would considerably exceed losses due to trade diversion not only for the area as a whole but for each of its individual members. Although these results hold only for the high elasticity estimates other results not included in the paper indicate that a similar conclusion holds in the case of the medium and low elasticity cases.

Apart, however, from subsequent dynamic reactions to the establishment of free trade, the possible cost of necessary balance of payments adjustments needs also be considered. In the case of Australia the projected 6% deficit is a large one - equal as a proportion to 3.6% of G.N.P. The possible deterioration in Australia's terms of trade required to eliminate this deficit could involve a substantial real income loss.

Dr. Wilkinson's paper also emphasizes the difficulty of predicting with accuracy the likely impact of free trade upon the various members of the PAFTA group. Apart from other factors the range of elasticity coefficients used yield estimates of trade creation effects which vary by several hundred percent in the case of all countries. In these circumstances, it is unlikely that the governments concerned would accept the establishment of free trade when so little is known about the likely consequences of it upon income distribution; employment and real income in their respective economies.

Let me close with a number of minor observations. I would query the estimated effects of New Zealand's devaluation upon her 1966 trade figures. Casual observation of the subsequent reactions to the devaluation suggests that the elasticity estimates applied by Dr. Wilkinson to the New Zealand case are much too low.

I fully agree with Professor Wilkinson's remarks on Japanese agriculture but with the Chairman and Dr. Wilkinson's permission discussion of this issue may be best left until the next session as it is discussed in my own and Professor Castle's papers.

A related point is that he sees the problem of manufacturing industry in New Zealand and Australia as a more intractable one than that posed by Japanese agriculture. He argues that the manufacturing sections in New Zealand and Australia involve a larger share of each nation's labour force and a larger share of their voting population than does the agricultural section in Japan. I would like to make two comments. First, only a small portion of manufacturing industry in Australia and New Zealand is protected. Secondly, the proportion of the workforce engaged in manufacturing in these countries is only slightly larger than is the proportion of the workforece engaged in agriculture in Japan.

Finally, I would argue that Dr. Wilkinson underestimates the social and political factors involved in the agricultural problem in a number of communities when he contends that "politicians and economists too, tend to overestimate the political strength and importance of the agricultural sector."

COMMENT ON PROFESSOR WILKINSON'S PAPER BY PROFESSOR JOHNSON

It is always a pleasure for an economic theorist like myself to read a piece of empirical research that has been carefully executed in detail, and guided at every step by critical knowledge of the relevant theory. Professor Wilkinson's past work has established him as an expert in this line of business, and the present paper conforms to that high standard; it is both a contribution to our understanding of the likely effects of PAFTA on trade volumes and patterns, and a contribution to the technology of estimates of this kind.

Let me take the technical contribution first. Estimates of this kind, relying on the empirical work that has been done in estimating elasticities of various kinds in international trade, typically proceed in two steps. First, an overall demand elasticity is used to determine the trade creation effect. As Professor Wilkinson implies, this procedure has frequently been followed blindly, without thinking through its theoretical implications. Specifically, he notes that the overall elasticity of world demand for exports is usually assumed to apply to the exports of an individual country, whereas elementary theory tells us that the elasticity of demand for an individual producer is overall elasticity divided by his share of the market. (This is on the assumption that quantities supplied by other producers remain constant.) Professor Wilkinson's new contribution is to notice this discrepancy between theory and practice, and to attempt to make a reasonable approximation for that part of the increased world demand for the product class as a whole, consequent on a price fall, that might be supplied by the individual supplier country when the tariff on its exports is eliminated in one market. In addition, I should remark, he has clarified the concept and application of elasticity of substitution in the context of the trade diversion effect.

In my view, Professor Wilkinson has called our attention to a real problem in our techniques of estimation, which arises from our assumption that in aggregate world trade a commodity classification supplied by several countries can be treated as homogeneous, for purposes of demand analysis, but that in the analysis of devaluation and discriminatory tariff reduction, national suppliers should be treated as imperfect competitors, an assumption embodied in a non-infinite elasticity of substitution.

Professor Wilkinson's procedure involves taking the homogeneity assumption seriously, by assuming that the price reduction implicit in a preferential tariff elimination generates the same increase in demand as an across-the-board price reduction, and then correcting this assumption in the light of the second assumption mentioned, that countries cannot supply perfect substitutes for all of each other's products. This is a defensible solution to the problem, though it poses another problem of consistency between the assumption of modified homogeneity used in this part of the estimation procedure and the assumption of heterogeneity used in the estimation of trade diversion. But I am not entirely satisfied with it, and would like to venture two remarks in that connection.

The first is that there is a need to rethink from first principles, without regard to the form that existing estimates in international trade have taken, what the relevant elasticities should be. For this purpose, it would seem to me most appropriate to regard each country's goods as differentiated from those of the others, and to consider the substitution part of the elasticity of demand for them in a particular market to be made up of a sum of substitutions against domestic goods and against foreign rivals, the former expressing trade creation and the latter expressing trade diversion possibilities.

The second remark is an attempt to recapture something I worked out in connection with a review, written in 1963 and published in 1964 in the Review of Economics and Statistics and not to hand now, of the Brookings group's study of the U.S. balance of payments in 1968. If we assume that the aggregates of commodity classifications are meaningful, we should treat their components not as homogeneous but as a bundle of complements, the demand for which depends on the average price of the bundle. On this basis, a reduction in the price of the supply from one source, due to devaluation or preferential tariff reduction, will reduce the average price of the bundle by the proportional price reduction of the component multiplied by the share of the component in the total. If we then multiply the average price reduction by the elasticity of demand for the component (overall elasticity divided by component share) we arrive back at the overall elasticity multiplied by the proportional price reduction of the component as the correct measure of the trade-creating increase in demand for the supply from the component. In other words, the overall demand elasticity, not the elasticity of demand for the component only, is the correct parameter to use, and the standard pre-Wilkinson procedure is the correct one to apply on the trade-creation side. However, the assumption of complementarity then is inconsistent with the assumption of substitutability employed on the trade diversion side. Consequently, the matter cannot be left as it stands. As already mentioned, I am not satisfied that our procedures of aggregating national supplies for purposes of demand elasticity analysis, and disaggregating again for purposes of substitution analysis, reflect basic economic behavioural relationships rather than mere statistical response to the way the data are presented to us.

Turning to Professor Wilkinson's specific estimates, these turn out in broad terms more or less as expected: the countries which are in a position to export manufactures to the United States (Canada and Japan) are predicted to gain trade on balance substantially while those with protected high-wage manufacturing (the U.S.A. and Australia) are predicted to lose trade on balance ("gain" and "loss" referring to the overall trade balance), these predictions reflect in large part the much higher elasticities of demend assumed for manufactures than for other categories of traded goods; the use of elasticity estimates to predict the effects of major changes in trade policy may be suspect, for example because free trade might enable producers of primary products to extend into the production of manufactures based on those products as inputs. In this connection an analysis in terms of effective rather than nominal protection might be useful, though as research has shown the measurement of effective protection is extremely difficult to carry through with reasonable accuracy.

In his final section Professor Wilkinson deals with some qualitative considerations, and particularly the dynamics of industrial location and the exploitation of technology. These considerations suggest that Canada, Australia and New Zealand will do less well than the static analysis indicates, since industry in the area will tend to agglomerate in the largest industrial complexes. In the case of Canada, the argument is somewhat inconsistent with the findings of R.J. and Paul Wonnacott, in their study of the consequences of free trade between Canada and the United States, that the Niagara peninsula has substantial locational advantages in relation to the United States market. Of course, how far the agglomerative tendencies in industry associated with the production and marketing of new technologically based products would operate in a Pacific Free Trade Area would depend in part on how far the agreement dealt effectively with non-tariff interventions in international trade and on how firmly the agreement was expected to endure.

Chapter 4

ASIAN DEVELOPING COUNTRIES AND PAFTA: DEVELOPMENT, AID AND TRADE PREFERENCES

Kiyoshi Kojima

I. A New Stage in the North-South Problems

The second United Nations Conference on Trade and Development (UNCTAD) at New Delhi in February-March, 1968, ended with frustration and disappointment for the developing countries.[1] This was not surprising since it was held at a very unfavourable time when the developed countries were involved in difficulties of their own such as the devaluation of sterling, the gold crisis, and a rising tide of restrictive and protectionist foreign trade and aid policies in the United States. The main positive achievement of the conference was an agreement to proceed with the establishment of a "General System of Preferences" for developing country exports of manufactures, to be worked out in the course of 1968-69 and, hopefully, implemented in 1970.

An important question arises. How effective is a global approach to the North-South problem likely to be? It is doubtful whether a multi-country meeting of this scale can substitute for more intensive negotiations between a small number of countries. The problems raised by the persistence of the basic cleavages of interests both within and between the two groups of developed and less developed countries are multiplied by more than the number of countries involved.[2]

Even if agreement could be reached, concessions are likely to be severely limited and of nominal value. It is urgently necessary to formulate a more effective and constructive approach to the problem. A regional approach in which like-minded countries, from both the developed and less developed group, endeavour to foster trade and development among themselves seems more promissing.

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1 UNCTAD, The Significance of the Second Session of UNCTAD, report to the Secretary-General of the United Nations, TD/96, 7 May 1968.

2 See, for example, David Howell, "Failure at UNCTAD II," The Round Table, July 1968, pp. 249-253.

However, a regional approach can not be a substitute for a global approach to development problems. Rather, it represents an effective step towards the global approach.

Currently, the North-South problem seems to be facing a turning point: there is a shift in emphasis from aid and trade expansion of a "vent-for-surplus" type to that of a "structural adjustment" type.

In the last decade, less developed countries sought as much aid as possible from the developed countries. This aid was mainly used to provide social overhead capital and to fill in the gap in the trade balance incurred by accelerated imports of capital equipment. In short, it was not really directed towards increasing exports. However, foreign substantial debts have accumulated in many developing countries and repayments and service charges surpass new borrowings. Thus, in addition to increased aid and a softening of terms of aid, the expansion of exports from developing countries is an urgent task.

Since economic development in many developing countries has been confined to investment of the "infrastructural" type and the establishment of import-substituting industries, exports have continued to consist mainly of traditional primary products. These exports have suffered from a declining importance in total world trade and also from severe fluctuation in their prices. Prospects for these exports look even worse because of the rapid growth in the supply of synthetic substitutes and the world-wide tendency towards trade liberalisation both of which make things even harder for the low-quality, high-cost type of exports of the developing countries.

Thus, developing countries must turn to the expansion of export-oriented productive activities. The expansion of exports, not only in speciality tropical goods but also in certain labour-intensive manufactured and semi-manufactured goods, appropriate to the factor endowment ratio in developing countries, now seems the most promising line of economic development. Developing countries have to shift the emphasis from receiving aid to the expansion of exports, and from agricultural exports to a structural transformation of their economies towards the export of manufactures.

Developed countries should take appropriate measures to facilitate structural transformation in developing countries. However, in the last decade, developed countries have confined themselves significantly to providing the vent-for-surplus type aid. U.S. aid in the form of surplus agricultural products under Public Law 480 is one good example. To take another example, Japanese aid has so far been provided mainly for the purpose of increasing her own exports of heavy manufactures and chemicals. Japanese reparations to Asian countries up to about 1960 were directed towards stimulating the expansion of newly established heavy industries and at the same time absorbing a large amount of unemployed labour. Aid from developed countries has been provided partly because there has been surplus produce or surplus capacity in resources, and aid has served as the vent for these surpluses.

Since about 1960, developed countries, including Japan, have been subject to more inflationary pressure. Aid of the vent-for-surplus type could not be continued easily. A new concept of aid and new aid policies have become necessary.

New types of aid and access for the exports of the developing countries to the markets of the developed countries should be provided by means of the structural adjustment of industries in developed countries. The developed countries would be better off substituting the production of a number of domestic industries for imports from the developing countries. There are certainly some "declining" industries in the developed countries which are so old and inefficient that, from all the criteria of comparative advantage and efficiency in resource allocation, it would be better to phase out of existence. Productive resources thus released should then be transferred to promising growth industries, effective demand for the products of which would be increased as a result of the successful economic development in less developed countries. Given that full employment is maintained, this sort of structural adjustment in the developed countries is the only real way to increase national incomes. Moreover, only this kind of structural adjustment in developed countries could create room for expanding exports from developing countries. Structural adjustment on both sides is required in order to achieve a "new international division of labour" and the better utilization of world resources.

Recently it was convincingly demonstrated by Hal B. Lary that "the ranking of industries by factor intensities is much the same from country to country, even from the most developed to the least developed. That is to say, the phenomenon of 'factor-intensity reversals' seems to be much less common, at least in manufacturing, than some other empirical studies would suggest."[3] I also have verified the validity of the factor-proportions theorem as regards exports of manufactures (74 commodities) from the U.S., Canada, Sweden, the U.K., EEC and Japan.[4] These studies lead to support the conclusion that the potential manufactured exports from less developed countries is promissing, provided that a receptive and cooperative attitude is adopted by the importing countries and an appropriate export-oriented industrialization policies suited to their factor endowments are pursued by the less developed countries themselves. "A readiness on both sides to share in the international division of labor among countries at varying levels of economic development"[5] would assure successful growth in trade from less-developed to developed countries.

One of the most important consequences of the validity of the factor-proportions theorem is that trade in manufactured goods throughout the world should be liberalized. This liberalization is necessary to maximize world productivity by providing increased opportunities for international division of labour in manufacturing industries among countries at different stages of economic development and pressing factor endowments. This means that advanced countries should abolish the protection given to their declining labour-intensive industries, as rapidly as possible, transferring the production of these goods to less developed countries. To achieve "a new international division of labour"[6] the growth of promising manufacturing industries suited to the factor-proportions

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3 Hal B. Lary, Imports of Manufactures from Less Developed Countries, National Bureau of Economic Research, New York, 1968, p.19. Total value added per employee which are taken to represent the difference in capital-intensity in 13 industry groups are compared among 9 countries (the U.S., Canada, Australia, Sweden, the U.K., Japan, Brazil, Mexico and India) and both Kendall's coefficient of concordance (0.853) and chi-square test (92.12) are very significant (Ibid., p.71)

4 Kiyoshi Kojima, "Comparative Advantage among Industrial Countries: A Verification of the Factor-Proportions Theorem," (forthcoming).

5 Hal B. Lary, Ibid., Preface, p.xv.

6 Harry G. Johnson, Economic Policies Toward Less Developed Countries, Brookings Institution, Washington, D.C., 1967, pp. 201-204.

of the less developed countries should be assisted by capital and technological aid and by the extension of tariff preferences.

Structural adjustment in developed countries is an essential element if new development policies are to be successful. Structural adjustment is also a key factor in the liberalization of trade and the establishment of a free trade area among the advanced countries. How can this structural adjustment be undertaken effectively? Strong resistance both economic and political, can be expected. Various steps will have to be taken to assist the adjustment, along the lines of those under the U.S. Trade Expansion Act of 1962 and the amended act of 1968.

There are two measures that would assist the adjustments desired. First, a fund for assisting structural adjustment should be established in every advanced country. This should become an international obligation similar to the one per cent of national income foreign aid target. A certain per cent (say, a quarter of one per cent) of national income could be collected through taxation for this purpose. The fund should be used for bringing about the gradual elimination of uneconomic industries and the transfer of factors of production to more productive activities where the advanced country enjoys a comparative advantage. The optimum policy would be a "package" of subsidies to allow uncompetitive production to continue over the retirement period and of cash grants to finance the closing down of capacity. Facilities should be provided, in addition, for the retraining and movement of redundant labour.

This fund would be more efficient than direct aid to developing countries for it could be used in the advanced countries for economic rationalization and thus raise national welfare in their own interests. In many advanced countries, slum clearance has been widely undertaken by governments. Why should not the reclamation of uneconomic industries be undertaken also?

Secondly, some safeguards for gradual running down of inefficient, heavily protected industries in the developed countries should be devised. A Tariff Board should be established in each developed country or preferably as an international institution, which obliged industries to justify their claim for continued protection by tariffs and quantitative controls. The subsidies noted on an annual basis should replace tariff protection for uncompetitive production. Each year subsidised producers could be required to make out a case as to why they should continue to receive cost-reducing subsidies rather than grants designed to facilitate the running down of their productive capacity.[7]

In this way the burden of maintaining protected industries would fall on the consumers and taxpayers of the developed countries concerned rather than on the less developed countries and other exporters. Consumers in the developed countries would thus be more clearly aware of their interest in seeing uneconomic industries closed down and the harmful effects of tariffs and quantitative restrictions than they seem to be at present.

Careful investigation should be made as to how best to provide aid and preferences for the purpose of facilitating structural adjustment with the least friction and greatest incentives in the advanced and less developed countries alike.

II. Directly Productive Aid

I have advocated closer economic integration among the Pacific basin countries, preferably the formation of Pacific Free Trade Area (PAFTA) but, as a first step, the establishment of an Organization for Pacific Trade and Development (OPTAD).[1] Trade liberalization among the five advanced countries of the Pacific, the U.S.A., Canada, Japan, Australia and New Zealand, would bring about a large expansion of intra-areal trade (as large as $US5,000 millions or 28 per cent of intra-areal trade in 1965) which would be more significant than what can be expected through the Kennedy Round tariff reductions. Complete regional trade liberalization would appear to have considerable advantages over partial trade liberalization in world markets. Since another major round of global tariff reductions is not feasible within the foreseeable future,

7 David Wall, The Third World Challenge, Preferences for Development, Atlantic Trade Studies, London, January 1968, pp. 61-62.

1 Kiyoshi Kojima, "A Pacific Economic Community and Asian Developing Countries," Hitotsubashi Journal of Economics, June 1966, and "Japan's Interest in the Pacific Trade Expansion," Kiyoshi Kojima (ed.), Pacific Trade and Development, Japan Economic Research Center, February 1968 (reprinted in Hitotsubashi Journal of Economics, June 1968). cf. G.C. Allen, Japan's Place in Trade Strategy, Larger Role in Pacific Region, The Atlantic Trade Study, London, September 1968..

the formation of a free trade area would seem to be an effective alternative for, and the only remaining practial road to, fostering world trade liberalization.

Moreover, the formation of PAFTA or some such alternative is particularly desirable from the viewpoint of developing well harmonized and efficient trade and aid policies[2] towards the less developed countries in the Pacific basin. If a PAFTA arrangement were established, the group of developed countries could (and should) offer associate membership to the less-developed countries of the Pacific and provide the latter with aid, investment and trading privileges. To increase aid and trade with less developed countries, what is most needed is, structural adjustment of industries in the developed countries as explained above.

The creation of PAFTA would imply that each member would be prepared eventually to adjust to full competition from the other member countries. This would certainly provide developed countries with a great impetus to undertake structural reorganization and, if this could be started, it would not be difficult to include structural adjustments required to provide the less developed countries with wider markets. Each advanced country in isolation might be reluctant to grant aid and trading preferences to less developed countries on the scale required, either because of its lack of resources, or because it could not face alone the structural consequences for its own economy. Only harmonized and coordinated efforts among the advanced countries would make aid and trade expansion with less developed countries possible. The increased prosperity and higher incomes which the advanced Pacific countries would gain through PAFTA would provide them with additional resources which they could share with less developed countries of the Pacific. Only the process of rapid economic growth within the developed countries, stimulated to some extent by trade liberalization, makes possible structural adjustment.

Aid and trade preferences should be provided from advanced to less developed countries of the Pacific in a direction which would accelerate most the structural adjustment needed on both sides most. With this aim, it is strongly recommended that international econom-

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2 See, David Wall, The Third World Challenge, Preferences for Development, The Atlantic Trade Study, London, January 1968, and "Markets for the Underdeveloped," The Round Table, October 1968, pp. 406-407.

ic aid should be increasingly provided to Asian (and Latin American) developing countires by the advanced Pacific countries in the form of machinery, equipment, fertilizer, and other capital goods for directly productive (preferably export-oriented) activities in the coming decade. Both humanitarian and infrastructural aid which were the main form of aid in the past can continue to make an important contribution in the future, but in addition to these types of aid directly productive aid is more urgently required now. As mentioned above, it can be expected that an increase in directly productive aid will have several beneficial effects not only for the developing countries but also for the donor countries.[3]

Suppose there was an outright grant of $US 1,000 millions annually for the coming ten years, in addition to the current level of aid, to the Asian developing countries from the five advanced countries of the Pacific, specifically for the purpose of the importation of machinery, equipment, fertilizers, and other capital goods. This would certainly stimulate the expansion of heavy and chemical industries in advanced countries, and many other such indirect effects could be anticipated.

Private capital investment in the developing countries should also increase, if the capital requirements of new manufacturing industries, which need such large and risky investments that private firms sometimes hesitate to undertake the investment, are met by international grants and, in addition, if preferential treatment of their exports by the advanced countries is assured. Private capital would assist in establishing a series of ancillary, interrelated, or higher-stage processing industries. For example, a big cotton spinning mill could be established by international grants; then the weaving and clothing industries might be supplemented by foreign private as well as local capital. The mill would produce yarn cheaply, owing to low capital costs, and ancillary and interrelated industries would become profitable.

Private capital investment from advanced countries would be stimulated. Increases both in the directly productive aid and in the

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3 A more detailed explanation is presented in Kiyoshi Kojima, "A Proposal for International Aid," The Developing Economies, The Institute of Asian Economic Affairs, Tokyo, December 1964, pp. 337-357.

private capital investment would create directly, and in addition through the "acceleration effect" indirectly, a new demand for heavy and chemical industries in the advanced countries. Moreover, the expansion of those industries would have multiplied income effects resulting in further additional demand.

A substantial expansion of heavy and chemical industries in the advanced countries could provide a stimulus large enough to reallocate resources in such a way as to expedite a rapid transfer of labour and capital (with the aid of adjustment assistance, if necessary) from agriculture and light manufactures of a labour-intensive type to heavy and chemical industries, that is, from comparatively disadvantageous to advantageous industries. Both the structural adjustments and increased national income in the advanced countries would enlarge the scope for importing certain kinds of agricultural products and light manufactures of a labour-intensive type from developing countries. Thus, if both the necessary capital goods, including technical know-how and managerial skill, and markets are provided, the expansion of export-oriented activities in the developing countries will be assured of success.

To sum up, my proposal for increasing international economic aid towards the provision of directly productive capital goods would have three distinct advantages. (1) It would provide the developing countries with the means necessary to expand export-oriented activities. (2) In the advanced countries, it would lead to a reallocation of resources towards heavy and chemical industries in which they possess a comparative advantage. (3) The expansion of heavy industries stimulated, in the advanced countries, by the increase in demand for capital goods in the developing nations, would provide the markets necessary for growing export industries in the latter. Thus, the international division of labour would move closer towards an optimum.

III. Agricultural Development in Asian Developing Countries

Although the expansion of the exports of manufactures suited to their abundant supply of labour is becoming the most promising path to long-term development for Asian developing countries, agricultural development is an even more urgent task in order to economize foreign exchange, to increase export earnings and to feed their people better and elevate their will to work. Pacific advanced countries (PAC) should provide directly productive aid to facilitate agricultural development in Asian developing countries.

(i) A Scheme for Fertilizer Aid

Although the countries of Southeast Asia, such as India, Pakistan, Indonesia, and the Republic of Korea, are agricultural countries they suffer from severe food-shortages and import foodstuffs to the approximate annual value of $US 1,000 millions from advanced countries in the Pacific area such as America, Australia and Canada. Although some of these imports are available in the form of American surplus agricultural aid, this is exercising a serious pressure on their already unfavourable balance-of-payments position. What is more, when future increases in population and per-capita consumption are taken into consideration, these countries will require a large increase in production, equivalent approximately $US 3,500 millions per annum, and foodstuffs to the value of approximately $US 1,000 millions will have to be procured in addition to the plans for increased production already tabled by the governments concerned. There is an urgent need to improve the food-producing capacity of those Asian countries in order to cover the $US 2,000 millions deficit in foodstuffs--the $US 1,000 millions already being imported from the advanced countries plus the $US 1,000 millions worth of additional production. The provision of chemical fertilizer aid and the construction of fertilizer factories, would seem the best method of attacking this problem.

Advanced countries of the Pacific area should shift the emphasis in their agricultural assistance programs from the provision of foodstuffs themselves to the provision of fertilizer aid. While the supply of surplus agricultural products under the American PL480 program is very useful for relief in times of famine, it has made little contribution to improving agricultural productivity in Southeast Asia. On the contrary, it has even tended to impair the morale of the local peasants. Fertilizer aid and the building of fertilizer factories involve much lower expenditure than assistance in foodstuffs. Today, now that America's stocks of surplus agricultural products are beginning to dry up, a switch towards emphasis on fertilizer aid would be advantageous.

A number of facts already testify that crop yields increase greatly if chemical fertilizers are applied appropriately. While production of rice per hectare is more than four tons in Japan, and around three tons both in the Republic of Korea and Taiwan which follow Japan, in the other countries of Southeast Asia yields are only about 1.2 tons per hectare, the lowest being India with 0.4 of a ton per hectare. The yield per hectare is clearly related to the quantities of fertilizers used, low productivity being caused by the virtual non-application of fertilizer. To take another example, of the total increase in food production of 11.2 million tons provided for under the second Indian Five-Year Plan (1956-61), 4.6 million tons or almost half was estimated to be produced by the increased use of chemical fertilizers.

For chemical fertilizer to be used effectively it is of course necessary that irrigation and drainage facilities should be provided in advance. Although not all Southeast Asia is ready to employ fertilizers, a fairly extensive area is. Increased production should be brought about by increased use of fertilizers, beginning in the regions in which the pre-conditions have been established. At the same time technical advice about the use of fertilizers, insecticide, and improving the seed strains should also be made available. It is an encouraging fact that superior seed strains such as IR-8 and ADT-27 have been developed and successfully used over a wide area. The diffusion of these modern agricultural inputs will take a long time and will need assiduous technical help and institutional reform, but they have already offered great hope for progress in Southeast Asia.

The main features of the scheme for fertilizer aid are as follows:

1) PAC should give a gift of fertilizers to the value of $US 60 millions yearly, or a total value of $US 300 millions over a five-year period to the countries of Southeast Asia which are in a position to use them.

2) The countries which receive these gifts of fertilizer should sell it at appropriate prices to the farmers, and should accumulate the proceeds as counterpart funds.

3) At an appropriate time factories for the production of fertilizers should be set up in the aid-receiving countries. When this is done the counterpart funds should be used to pay for such local expenses as acquisition of land, local labour costs, the remuneration of PAC personnel dispatched, etc. The equipment required in setting up these factories should be supplied from PAC on a long-term, deferred-payment basis.

4) The counterpart funds should be used for the following purposes in addition to the construction of fertilizer factories: a) additional or supplementary irrigation works directly necessary for

fertilizer application; b) running expenses necessary for PAC's agricultural technical cooperation activities (experimental centers, pilot or model farms, technical direction, extension work with improved strains of seed, etc; c) the purchase of agricultural machinery and implements, seeds, insecticide, etc; and d) the establishment of fertilizer storage and transportation facilities.

In summary, this is an aid formula under which fertilizers (especially nitrogenous fertilizer) for which PAC has a surplus productive capacity are first given as gifts, followed by which fertilizers factories will be built for the aid-receiving countries with the help of their counterpart funds and capital supplied under deferred-payment arrangements.

For example, if in the first year $US 60 millions worth of fertilizer aid were given to India and Pakistan respectively, in the second year two standard factories with a daily capacity of 600 tons of ammonium and 1,000 tons of urea could be built in each country. The cost of building one of these factories is estimated at $US 25 millions for the plant, and about $US 15 millions for local costs (to be met out of counterpart funds). In addition to this, during the second year both Indonesia and the Philippines should each be given gifts of fertilizers to the value of $US 30 millions. In the third year, two fertilizer factories should be built in each of these two countries. In the small countries of Southeast Asia, it would, of course, be proper to make the fertilizer factories small-scale ones of half, or quarter, of the capacity of the standard factories. It would also be possible to effect exchanges among the countries receiving fertilizers and countries building factories with their counterpart funds (e.g. by exchanging fertilizers produced in India for Burmese or Thai rice), a variety of flexible applications of the scheme being conceivable.

Fertilizer aid at the rate of $US 60 millions yearly, or $US 300 millions over five years, seems modest, both from the point of view of PAC's ability to meet the burden and its surplus capacity in fertilizer production. This aid alone would be probably be sufficient to make up the whole of the $US 2,000 millions increase in food production required by Southeast Asia, which was mentioned above. It is to be hoped that other advanced countries in Western Europe would also participate in the fertilizer aid scheme.

PAC would not only be enabled to carry through a meaningful aid programme aimed at the solution of the most urgent problem of food shortage in the countries of Southeast Asia, but the deferredpayments scheme would also enable PAC to export fertilizer plants and equipment valued at as much as $US 500 millions over a five-year period. Once the farmers of Southeast Asia became thoroughly familiar with the use of fertilizers and conscious of their value, the demand for fertilizers could be expected to increase, and even the demand for commercial exports of fertilizers from PAC could be stimulated.

(ii) A Program for Cash Crop Plantations

There is a strong desire for industrialization in the countries of Southeast Asia, but as capital equipment imports for the purposes of industrialization are costly developing countries commonly fall into serious balance-of-payments difficulties. If along with the above-mentioned increased food production, which reduces the demand for foreign exchange, it were possible to enlarge exports of such cash crops as raw cotton and sugar, their additional foreign exchange earnings would become available for the promotion of economic development.

There is considerable scope for the Pacific advanced countries to switch the imports of raw materials and foodstuffs from other advanced countries in the Pacific or Europe to Asian developing countries for those primary products which can be produced in Asian developing countries competitively in terms of quality, price, delivery, etc. Between five and ten years should be allowed for the developing countries to improve productivity and to increase export capacity. For advanced countries too, some time will be required for adjusting their industrial and employment structures.

The possibilities for switching sources of supply are especially great in Japan's case. Japan will have to import increasingly large quantities of raw materials, fuels and foodstuffs to sustain its expanding economy. In 1965, Japan imported two-thirds of its total consumption of energy -- mostly in the form of petroleum. Japan will continue to import most of the iron ore and non-ferrous metal ores it requires.

Its imports of raw cotton and raw wool may decline somewhat, but Japan must continue to rely on imports for its entire consumption of these raw materials. In 1966, lumber was Japan's second largest import, coming only after petroleum, and imports will further increase in the years to come. Imports of animal feeds such as maize and kaoliang are rapidly increasing. In 1966, Japan's fodder imports amounted to 5.7 million tons; and in the near future they will exceed the 10 million ton mark. Imports of oil seeds, sugar, bananas, and marine products will also expand. If Asian developing countries can produce these products efficiently, they will be able to expand their exports to Japan greatly.[1]

For the U.S.A., Canada, Australia and New Zealand, the possibility of increasing imports of raw materials and foodstuffs from Asian developing countries may be limited only to their traditional imports from these countries, but rapid economic growth and structural adjustments in these advanced countries will induce fairly large increases in imports from Asian developing countries for those traditional goods. It is hoped that those advanced countries are able to refrain from expanding competitive agricultural production through the abolition of support schemes and protection.

For agricultural products which Japan is importing both from the advanced countries of the Pacific area and from Southeast Asia, possible increases in Japanese imports from Southeast Asia are expected to amount to about seven or eight hundred million dollars within the next five years, if one takes into account the possible trade diversion effects away from the advanced countries and towards imports from the developing countries envisaged by our plan as well as the influence of the general increase in imports projected for Japan during this five-year period. Increased demand for Asian agricultural products in other Pacific advanced countries will be approximately the same as in Japan, making a total of roughly $US 1,500 millions.[2] It is desirable to have this met by increased production in Southeast Asia brought about by the efficient use of directly-productive aid. Although it is not easy to estimate the amount of aid required. The importation of investment goods to be used in the agricultural development projects backed by Pacific advanced countries (PAC) alone would require $US 240 millions. This figure is obtained from the estimates of the capital coefficient in Southeast Asia (1.6) and the foreign exchange requirement rate, (0.1), together with the projected total increase in demand for the agricultural products of Southeast Asia of $US 1,500 millions.

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1 Saburo Okita and Akira Ohnishi, "Japan's Role in Asian Economic Development," Kiyoshi Kojima, ed., Pacific Trade and Development, Japan Economic Research Center, Tokyo, 1968, pp. 360-361.

2 Some estimates were attempted in Kiyoshi Kojima, "A Pacific Economic Community and Asian Developing Countries," Hitotsubashi Journal of Economics, June 1966, pp. 30-37.

If this sum is provided over a five-year period about $US 50 millions annually would be sufficient.

As an efficient aid formula would be to grant funds and technology for the establishment and operation of cash crop plantations. Possible cash crops to be grown on these plantations would be cotton, maize, sugar, soybeans and tobacco. Here, however, I should like to consider a plan for a cotton plantation company as a representative of such undertakings.

1) The PAC would disburse aid at an annual rate of, say, $US 30 millions or a total of $US 150 millions over five years in the form of technical cooperation expenses, and would set up a parent cotton plantation company. It would probably be best to entrust the running of the company's affairs to efficient private enterprise.

2) The cotton plantation company would set up and run a number of cotton plantation joint enterprises organized with the help of local capital in suitable areas of Asia.

3) As well as exercising control over the joint enterprises in their various locations the parent company could provide technical assistance, and would send out technicians on an organized basis. At the same time it would carry on research in marketing and technical questions of common interest, and would make joint purchases of fertilizers, machinery, agricultural implements, etc.

4) The cotton plantation joint enterprises set up in various parts of Asia would possess the following attributes: a) They would have at least one primary processing factory, i.e., a factory where the seed and waste are removed by ginning machines and the selected material made up in bales, and then would possess plantations sufficient in size to make possible efficient use of the factory. b) They could carry out positive direction in relation to the cotton production carried on by peasant croppers in the vicinity of the plantation, buy up the raw cotton they produced, and carry out the primary processing. c) When a plurality of cotton plantation joint enterprises had been established in various areas in Asia, they would take steps to consider differentiating the varieties of cotton grown by the various joint enterprises in response to the needs of the demand for raw cotton in both PAC and Southeast Asia and with a view to distributing risks.

Japan imports most of her raw cotton from America at present, but it is quite possible from the technical point of view to grow American cotton in almost all parts of Southeast Asia, and it is already being grown extensively in Pakistan. What is needed is a switch in Southeast Asian cotton production to the superior variety of cotton, modern production management characterised by uniform quality, quality supervision, etc., and reduced costs. These should be the aims of the cotton plantation companies, and if they were achieved not only could PAC's imports of cotton from Asian developing countries be increased but it would also be possible to meet the demand for raw cotton which is rapidly increasing within Southeast Asia itself.

It would be possible to disburse PAC aid by the same method for the purpose of fostering offer cash crop plantations such as growing sugar, maize, soybeans, tobacco and other such cash crops. All these industries would produce results quickly with comparatively little aid and contribute to the solution of Asian balance of payments problems.

Concessions, and, positive support, by the advanced producing countries of the Pacific area will all be necessary to enquire the expansion of cash crop exports from Southeast Asia. The advanced countries will have to refrain from artificially stimulating their own exports, and, better still, substitute imports from Southeast Asia for domestic production. What reaction will be forthcoming from the American cotton producer is the chief worry. But it seems advisable for America to effect a gradual change-over from cotton production, which in that country is in process of losing its comparative advantage because of high wages and rising costs, to offer more profitable industrial activities, and further more that it might be more advantageous for American cotton growers to operate plantations in Southeast Asia where cheap labour is abundantly available. Thus, Southeast Asia should be given an appropriate role in changing the international division of labour. Similar adjustments are required in the production of American maize and soybeans and Australian sugar.

"Fertilizer aid" and "cash crop plantations assistance" are two examples of aid which could be provided by the cooperative action of the Pacific advanced countries and implemented immediately perhaps with the help of the Asian Development Bank. These directly productive aid projects should be additional to aid already planned for other purposes since much aid is also required to equip a huge agricultural infrastructure comprising large scale irrigation works, transport and communications facilities, education, as well as for undertaking land reform. The present scheme stresses the importance of complementary aid which allows the fruits of infrastructural aid to be realized.

The Pacific advanced countries should also assist with the development of mineral resources in Asian developing countries. This can be done best, however, mainly by private capital. Promising mineral resource developments in Asian developing countries are rather limited -- iron ore in India, petroleum in Indonesia, and copper in the Philippine. The development of mineral resources in Australia, Canada and Alaska presently appears less expensive and offers more stable supplies.

IV. Aid Trade-Preferences

Great faith has been put in general trade preferences to less developed countries as means of increasing their export earnings and promoting their economic growth. Trade preferences for developing countries are justifiable if divergence from the principle of non-discrimination within GATT is temporary and if they foster liberalization of world trade. They are positively desirable if they encourage transformation in the international division of labour in such a way as to strengthen specialization in the export of labour intensive exports from developing countries.

Will the general trade preferences bring about really substantial beneficial effects to developing countries as it is hoped they will? This question should be looked into.

(i) The Trade Creation Effects: Increases in Japan's Imports

Increases in Japan's imports due to the extension of general preferences to developing countries are estimated[1] according to the familiar model of tariff reductions, first neglecting the trade diversion effects which other developed countries might suffer. Attention is focussed on the trade creation effects on Japanese imports. The estimate is attempted with regard to 12 sensitive

1 A more detailed explanation is presented by Kiyoshi Kojima, "Trade Preferences for Developing Countries: A Japanese Assessment," Hitotsubashi Journal of Economics, February 1969, pp. 1-12.

items[2] of interest to developing countries on the basis of 1964 trade figures.

In 1964, developing country exports of these twelve commodities to Japan were valued at $US 3.69 millions which represented a 10 per cent share in the relevant Japanese markets. The estimates suggest that if tariffs were abolished on developing country exports to Japan, they would expand by $US 0.91 millions, or 24.7 per cent. Although the percentage increase appears large, the absolute size of the increase is relatively insignificant when compared with annual increases in Japanese exports of the order of $US 1,000 millions. The fact is that Japan still maintains a strong comparative advantage in traditional labour intensive manufacturing industries of the type most competitive with potential export industries in developing countries.

It is true that in recent years, Japan's imports of manufactured goods from Hong Kong, Taiwan, Korea, Singapore and India have been increasing rapidly, but they are still insignificant. However, taking this trend into account, and broadening the commodity coverage, it might be that around $US 50 millions worth of Japanese imports could be affected by the extension of trade preferences. If tariffs against developing country exports were completely eliminated, imports would increase by $US 13 millions only. A fifty per cent tariff cut is probably a more realistic possibility, and besides some commodities are likely to be excepted. On this basis, the increase in Japanese imports would be somewhat less than $US 6.5 millions. There seem no strong grounds for Japan to oppose the provision of general trade preferences for fear of unmanageable increases in her imports.

(ii) The Trade Diversion Effects: Decreases in Japan's Exports

A more serious problem for Japan is that her exports, particularly to North American markets, might suffer from the trade diversion effects of trade preferences extended by other developed

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2 They are mostly labour-intensive manufactures: Plywood, cotton yarn and thread, yarn and thread of synthetic fibres, cotton fabrics woven, floor coverings, clothing, footwear, articles of artificial plastic materials, travel goods and handbags, smallwares and toilet articles, children's toys, and lighters.

countries to developing countries. A more complicated model is required in order to estimate the effects of both trade creation and trade diversion in a given developed country market, such as the United States.

An estimate is attempted for nineteen manufactured commodities[3] of importance to developing countries which compete with Japanese exports in the American market. In 1964, United States' imports of these commodities were valued at $US 1,600 millions. Japan supplied $US 540 millions and developing countries supplied $US 465 millions. The nineteen items cover almost all the manufactured and semi-manufactured goods for which developing countries, as well as Japan, seek larger markets in the United States.

Let us suppose that the U.S. abolishes tariffs preferentially on the imports coming from developing countries while she retains tariffs on the imports from other developed countries. It is estimated according to our model that the developing countries would increase their exports to America by the amount of $US 176 millions or 37.8 per cent over the total 19 items on 1964 trade figures and enjoy an average rise of export prices of 18.3 per cent.

On the other hand, $US 22.5 millions or 4.1 per cent of Japanese exports would be diverted to developing countries and Japanese export prices would be forced down on average by 2.0 per cent. Thus, the United States would increase her imports by $US 153.5 millions or about 10 per cent on 1964 figures -- the difference between the increase in developing countries' exports and the reduction in Japan's exports. The increase in American imports is the trade creation effect of preferences resulting from the average fall of 2.0 per cent in American import prices inclusive of the tariff.

The question is would the effect of trade diversion on Japanese exports be really serious? Although there have been some exaggerated estimates for Japan, it is not likely that the effects would be nearly so serious as is widely feared, as far as the static effects of preferences are concerned.

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3 Cotton fabrics woven, yarn of wool, woolen fabrics woven, jute fabrics woven, floor coverings, clothing, manufactures of leather, footwear, sporting goods, children's toys, articles of rubber, plywood, cement, glass, glassware, soaps, sewing machines, bicycles, and radio broadcast receivers.

(iii) Preferences through an "Advance Cut"

Two alternative preference schemes have been presented to OECD countries: the advance cut plan advocated by the United States and the tariff quota plan supported by EEC countries. It has been suggested that the advance cut preference scheme could be applied either by reducing tariffs on developing country products to the full extent of concessions agreed under Kennedy Round negotiations or by reducing tariffs on developing country products under negotiations between developing countries and developed countries within GATT, to be followed by a new round of negotiations among developed countries designed to effect the staged reduction of MFN tariffs over 5 or 10 years. Either way, the advance cut plan ensures that general preferences are temporary and that they are consistent with progress towards global free trade. These are the the significant merits of the advance cut proposals.

On the other hand, the tariff quota scheme appears more open to protectionist abuses, and unlikely to promote trade liberalization in developed countries. Quotas on selected commodities from particular developing country sources would be subject to arbitrary alteration and MFN tariffs could even be raised to provide larger preference margins. Fundamentally, the tariff quota plan does not aim at progress towards global free trade but sets out to prevent "market disruption" by developing country products. From the standpoint of encouraging the expansion of world trade, the advance cut proposals seem preferable.

Permanent preferences, i.e., general preferences with no limitation in duration, are certainly more favourable to less developed countries than the AC plan, but they will not be accorded by developed countries. It may be interesting, however, to illustrate the difference in effects of both schemes for the case of Japan.

Let us suppose that (1) America imported in the initial year $US 600 millions from Japan and $US 400 millions from developing countries, following closely to the 1964 trade figures; (2) the American tariff level was 30 per cent ad valorem; (3) preferential margin equals 0.5 both under the AC plan and the permanent preferences plan; (4) tariffs are reduced by 10 per cent every year for five years under the AC plan but they are reduced by 50 per cent from the first year under the permanent preferences plan; (5) the price elasticity of American import-demand is taken as 2.5 and the price elasticity of export-supply from Japan 2.2 throughout the five years; and (6) the price elasticity of export-supply from developing countries will increase from 1.1 in the first year to 1.65, 2.2, 2.75 and 3.3 in successive years.

Under these assumptions, over the whole five year period, Japanese exports would fall by $US 205 millions or 6.8 per cent under the permanent preferences plan, whilst they would increase by $US 306 millions or 10.2 per cent under the AC plan.

Exports of developing countries would increase by $US 671 millions or 33.4 per cent in the case of the permanent preferences plan and by $US 514 millions or 23.7 per cent in the case of the AC plan.

American imports would increase by $US 466 millions, i.e., net of increase from developing countries and decrease from Japan, in the case of the permanent preferences plan whilst they would increase by $US 820 millions, i.e., the sum of increase both from developing countries and Japan, in the case of the AC plan.

Thus, it appears that a permanent preferences plan, if it were accorded, would be most favourable to developing countries. It should be noted, however, the increases in American imports which designates the degree of liberalization of world trade would be far larger in the case of the AC plan than in the permanent preferences plan. The more favourable effects for developing countries in the case of the permanent preferences plan resulted from discrimination caused by trade diversion effects against Japan and not from the greater expansion of world trade. Japan has many interests in common with developing countries. She still depends heavily on the export of traditional labour intensive manufactures in competition with developing countries but, like them, she desires freer access to developed country markets for these exports.

It is important to emphasise that for developing countries, too, the benefits of trade preference schemes derive not so much from discrimination in tariff treatment but more from the reduction of tariffs in developed countries and also from the increase in productive capacity and competitiveness of exportable products from developing countries. It is of the utmost urgency to the developing countries that some jolt be administered to the high-wage economies of the advanced nations so that protectionism is broken down and also so that they be given more efficient assistance from the advanced countries to foster their infant industries. These aims would be realized most practically through FTA aid and preferences.

(iv) PAFTA Aid cum Preference System

What this study and others have shown is that the static effects of preference schemes are not likely to be substantial.[1] The prospects are generally discouraging for developing countries. The benefits for them may be even too small to justify the cost of carrying out the cumbersome administration of preferential treatment. The increased earning power of developing countries which results from trade preference is certainly not likely to fill their huge foreign exchange gap.[2]

Moreover, there are conflicting interests among the potential preference-receivers. The main interest of the less developed among the developing countries is not so much preferential tariff treatment on manufactured exports but, first, the expansion of traditional primary commodity exports and, second, the initiation of industrialization with heavy dependence on aid from developed countries.

In fact, developed countries have been reluctantly lead towards the provision of general trade preferences, not because they expect any substantial benefits to flow to developing countries but because they recognize the political expedience of providing them.

It may be true that if the effective rates of protection which are on average 1.5 or 2 times over the nominal tariff rates,[3] and

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1 See, Gardner Patterson, Discrimination in International Trade, The Policy Issues, 1945-1965, Princeton, 1966, pp. 358-359, pp. 381-383. John Pincus, Trade, Aid and Development, Council on Foreign Relations, 1967, Chap. 6. Pincus, ibid., p. 231, estimates that a general preference scheme could increase the export receipts of developing countries by the general order of $1 billion annually if processed products were included. This estimate is the largest at several estimates made.

2 Grant L. Reuber, Canada's Interest in the Trade Problems of Less-Developed Countries, The Canadian Trade Committee and Private Planning Association of Canada, 1964, p. xii.

3 See, Harry G. Johnson, "Trade Preferences and Developing Countries," Lloyds Bank Review, April 1966, pp. 13-17, and Bela Balassa, "The Structure of Protection in the Industrial Countries and its Effects on the Exports of Processed Goods from Developing Countries," IBRD Report, No.EC-152a, February 1968.

the dynamic effects of preferences are taken into account, the favourable effects of general preferences for less developed countries would be more substantial. But these effects depend heavily upon the developed countries assistance of capital, know-how and management for establishing and rationalizing production facilities in developing countries.

An aid cum preference scheme could offer more benefits to developing countries. Aid, linked directly to preferential tariff treatment, appears consistent with the Prebisch report's emphasis on the infant industry argument for preferences.[4] Firstly, as proposed in previous sections, directly productive aid in the form of capital goods, advanced techniques of production, managerial know-how, and worker training, should be provided to developing countries on an increasingly large scale if the efficiency of new export-oriented industries, primary as well as manufacturing, is to be improved to the point where they become increasingly competitive in world markets. Secondly, developed countries should provide preferential treatment, say for five or ten years, to developing country exports launched with the help of directly productive aid. Preferences aimed at ensuring wider markets would serve as a sort of aid 'after-care', and might well be regarded as indispensable to realizing the full benefits of aid. It is important that the provision of preferences should be closely linked with the provision of preferences should be closely linked with the provision of aid since either is likely to be ineffective and result in a waste of resources if applied independently.

The aid <u>cum</u> preference scheme need not be confined to manufactured goods. It could also be useful for agricultural and mineral commodities of interest to developing countries. Commonly, however, developed country tariffs on these latter products are very low or non-existent and there is little margin for granting preferences. In such cases, governments of the developed countries could provide a subsidy on imports from the developing countries for some specific period, say five years, until competitiveness is sufficiently well established.[5]

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4 United Nations, <u>Towards a New Trade Policy for Development</u>. New York, 1964.

5 As a kind of aid, Japan has stressed "development investment for imports," i.e., to assist the development of primary products in developing countries with the aim of importing raw materials and foodstuffs most needed for the Japanese economy

It is clear that a large-scale scheme of aid cum preference could be provided more efficiently and without much difficulty by a group of like-minded advanced countries. This suggests the advisability of a Free Trade Area Aid cum Preference System.

The optimum arrangements for the less developed countries would be for as rapid as possible a reduction and elimination of barriers on their exports to FTA countries, combined with the slow and gradual elimination of barriers among FTA countries. It might be best to establish a FTA by eliminating tariffs gradually within ten to fifteen years but to reduce tariffs on developing countries products from the first year to the full extent, following on the principle of an advance cut plan. At the same time, FTA governments could increase directly productive aid and encourage the flow of private investment to developing countries which would be stimulated by these trade measures.

The FTA aid cum preference system has a number of advantages, including greater feasbility, over the general preference system considered by UNCTAD. These have been excellently summarized by David Wall as follows:[6]

In the first place, the spirit behind the FTA movement is based on belief in the benefits to be gained from free trade and the concessions called for in the proposed preference system would represent a more extensive diffusion of this particular spirit.

Secondly, if FTA was to be successfully established, its members would be better off and consequently able to bear the cost of the preference system more easily, which contrasts with the UNCTAD scheme that incorporates non quid pro quo for developed countries.

Thirdly, the extension of preferences by FTA as a group would ensure that the burden of accommodating those preferences would be shared as broadly as possible.

(5 cont'd) at a cheaper price and from a stable source. Thailand's export of maize to Japan is a good example. In order to promote this, an "Agency for Asian Trade and Development" will be established under the support of the Japanese Ministry of International Trade and Industry.

6 David Wall, The Third World Challenge Preferences for Development, The Atlantic Trade Study, London 1967, p.65.

In addition, such action would reverse the tendency for the world to break up into discriminatory trading blocs bent on protecting the interests of producers within each bloc.[7]

It should be stressed again that the jolt to the economies of the developed countries which the provision of preferences to the less developed countries entails would be alleviated by the formation of FTA. The creation of FTA implies that each member would be prepared, eventually, to adjust to full competition from other member countries. Only with such commitments would FTA countries be ready to provide preferences to developing countries more widely and effectively. It is practically impossible under present world trade policies to abolish non-tariff restrictions. The abolition of non-tariff restrictions could be realized between FTA members and the benefits extended to associated developing countries. Thus, the commodity coverage for reducing both tariffs and other trade barriers in favour of less developed countries would be much greater under FTA preference than under the UNCTAD scheme. Tariffs and other trade barriers for less developed countries would be completely eliminated by FTA preferences while only a fifty per cent reduction of tariffs might be the largest feasible tariff cut under the UNCTAD scheme. In addition, greater assistance from FTA countries would be assured. Thus, the FTA aid *cum* preference system would be more beneficial to less developed countries than a general system of preferences considered by UNCTAD.[8]

FTA preferences along the lines of the advance cut plan would automatically assure that the advantages to developing nation exporters would last as long as the period over which FTA members gradually removed barriers to trade among themselves, and also with respect to FTA imports from third party developed countries. On this point, it may appear to the less developed countries that FTA preferences would be less beneficial than permanent general

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7 The UNCTAD scheme of general preferences creates new discrimination, while FTA preference would prevent increased discrimination.

8 It should be remembered why the British Commonwealth preference has been beneficial to developing countries. Beneficial effects have been brought about mainly from all-round assistance in capital, management, marketing, etc., but not so much from preference itself. See, Donald MacDougall and Rosemary Hutt, "Imperial Preference: A Quantitative Analysis," *Economic Journal*, June 1954, p.269.

preferences. It should be noted, however, that any preference scheme should not be allowed to be permanent. The duration of the preference scheme should be long enough to allow the successful establishment of some industries, but not so long as to encourage the establishment of industries in which developing nations have no prospects of long term comparative advantage.

It might be claimed by the less developed countries that the FTA preference system is not general as regards countries which provide preferences, since the free trade area is unlikely cover the all developed countries. However, less developed countries may become associated with more than one FTA and receive preferential treatment from all that were prepared to provide it. Moreover, advanced countries could belong to more than one FTA. This possibility arises from the characteristics of free trade areas, which differ from customs union or more solid political unions. If more free trade areas provide non-discriminative preferences to any less developed countries generally, FTA preferences would really become more general and effective than those intended under the UNCTAD scheme.

V. Conclusion

The establishment of Pacific Free Trade Area or an alternative organization has the twin objectives of providing a step towards free world trade and of assisting more effectively the less developed economies particularly in Southeast Asia, in their efforts to develop. This paper has examined how the Pacific advanced countries can cooperate to increase directly productive aid for food-production, cash-crop plantations, and manufacturing industries to the Asian developing countries. It has also recommended that FTA preferences should be provided in close association with aid efforts.

To make those aid cum preference efforts fruitful both for the Pacific advanced countries and Asian developing countries, three steps are necessary. Firstly, trade liberalization among the Pacific advanced countries, preferably through the formation of a Pacific Free Trade Area, is a prerequisite for increasing their aid-giving capacity and for providing the necessary jolt to carry out structural adjustment which will allow the absorption of increased imports from developing countries. Secondly, the structural adjustment of industries in advanced countries is a key factor in the success of the entire PAFTA aid cum preference system. Thirdly, it goes without saying that efforts of self-help and considered policies for economic development in Asian developing countries are essential to the success of the scheme. Finally, improved financial arrangements in the Asian-Pacific region would facilitate the implementation of these trade and development policies.

Supplement to Chapter 4

AN ESTIMATE OF THE EFFECTS OF PAFTA PREFERENCES THROUGH AN "ADVANCE CUT"

Ippei Yamazawa

I

The aim of this supplement is to illustrate the effects on the expansion of exports from Asian developing countries which the provision of PAFTA preferences along the lines of the "advance cut" plan proposed in Section IV (iii) of Professor Kojima's paper would entail. Although trade figures are taken so as to represent the actual trade positions of the PAFTA countries in 1965, the calculations are made on the basis of an extremely simplified model and should be regarded only as a numerical illustration of the effects of the scheme.

II

Total imports are classified into four commodity categories, food (F), raw materials (R), light manufactures (L), and heavy manufactures (C). Domestic products of an importing country and imports from Asian developing countries, other PAFTA countries, and the rest of the world (ROW) are all assumed to be perfect substitutes for each other and are all sold at the same price in the market of the importing country.

Thus once a PAFTA country reduces its tariffs preferentially towards Asian developing countries, the latter's exports will expand in response to the increase in their export price (net of import duty), partly to fill the increase in the total import demand (the trade creation effect) and partly to replace imports from both other PAFTA countries and the ROW (the trade diversion effect). The increase in Asian developing country export earnings depends on export supply elasticities and the rate of increase in their export price, the latter being determined by the initial rate of tariffs and preferential tariff margin, import demand elasticities and export supply elasticities of the other two groups of exporters, and the initial shares of the three groups of exporters in the market.[1]

Tariffs are reduced preferentially among PAFTA countries gradually over the following ten years. As the tariff reduction proceeds, the other PAFTA countries will increase their shares in the markets of the member countries at the expense of domestic producers, the ROW and Asian developing exporters. Asian developing countries will suffer from a decrease in their exports through trade diversion effects due to tariff reductions in PAFTA. Thereby the effects of a preferential tariff reduction through "advance cut" can be estimated approximately by subtracting these gradual decreases in their exports shares through the trade diversion effect from the impact effects which the initial preferential reduction in tariffs entails.

However, if we take into consideration the fact that the export supplies of Asian developing countries are initially relatively inelastic, and that these elasticities increase gradually partly as a result of the aid-cum-preference scheme, then the export gains for Asian developing countries from the initial preferential tariff reduction mainly take the form of higher export prices. Thus the trade diversion loss of exports by the PAFTA members may not be substantial. In the next stage, Asian developing exporters may continue to increase their shares in the market since the increase in the elasticities of their export supplies could more than offset their trade diversion losses. In this way PAFTA preferences through an "advance cut" could provide an orderly path for export specialization both for Asian developing countries and for the PAFTA member countries. In addition, if the steady increase in total demand of importing countries over the ten year period is taken into consideration, the above scheme may be carried out more sucessfully.

III

Imports of the four commodity groups by each PAFTA country from Asian developing countries, other PAFTA countries and the ROW are given in Table 1. Tariffs are taken from the pre-Kennedy

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1 The formulae for the estimation are given in "Trade Preferences for Developing Countries: A Japanese Kiyoshi Kojima Assessment", Hitotsubashi Journal of Economics, February 1969, p.6

Round tariff table of each PAFTA country and are supposed to represent the average figures for the four commodity groups. Elasticities of import demand (η) are assumed to be - 1.0, - 0.6, - 4.0, and - 4.0 for F, R, L, and C respectively for the United States, while they are assumed to be - 0.7, - 0.3, - 3.0, and - 3.0 for other PAFTA countries if we take into consideration of the exceptionally large size of the United States. Elasticities of export supply (ω) are assumed quite arbitrarily to be 1.0 for F and R and 3.0 for L and C both for PAFTA countries and the ROW, and for the developing countries two alternative sets of assumed values are used viz. the same export supply elasticities as above and those same values halved. The preferential margin is 100%, in other words a complete elimination of tariff barriers towards Asian developing countries.

Table 2 summarizes the impact effects of the initial preferential tariff reduction by PAFTA countries for Asian developing countries with the two alternative sets of assumed values for elasticities of export supply. The rates of increase in the exports from Asian developing countries are substantial in L and C reflecting high elasticities both of import demand and export supply and relatively high levels of tariffs imposed on these commodity categories. The absolute amounts of their increases, however, are small in comparison with total imports of each country; both the rates of increase in total imports of PAFTA members (trade creation effects) and the rates of decrease in their exports (trade diversion effects) are 5~6% at most.

Table 3 illustrates the effects of PAFTA preferences through an "advance cut" by the United States: the level of her total imports, the exports of Asian developing countries and of other PAFTA members are given for the year 0 (before tariff reduction), 1 (when tariffs are reduced by 100% for Asian developing countries and by 10% for other PAFTA members), 5 (when tariffs are reduced by another 40% for other PAFTA members), and 10 (when tariffs are eliminated for both groups). Two alternative assumptions are made as to the elasticities of export supplies of Asian developing countries; (A) they are the same as those of other exporters and constant over ten years and (B) they are halved initially but increase steadily over ten years and amount to the same as those of other exporters in the year 10.

The two assumptions give two estimates for years 1 and 5 which illustrate two different sets of growth paths of the exports of Asian developing countries. With (A) constant elasticities of export supplies, the exports of Asian developing countries increase greatly in the first year but decrease over the following years, while with (B) increasing elasticities, their exports increase steadily over the whole period. The exports of other PAFTA members increase more steadily under the assumption (B). These figures suggest that PAFTA preferences through "advance cut" will provide an orderly path for export specialization both for Asian developing countries and other PAFTA members if the increase in elasticities of export supply of Asian developing countries as a result of the aid-cum preference scheme is taken into consideration.

Table 1 Imports of PAFTA Countries

	F *	R	L	C
U.S.A.				
Total imports	4010.8***	4969.0	5578.7	6807.9
from Asia**	364.5(9.1)	469.7(9.4)	683.5(12.3)	210.1(3.1)****
PAFTA	759.7(18.9)	1500.8(30.2)	2057.4(36.9)	3259.2(47.9)
ROW	2886.6(72.0)	2998.5(50.8)	2837.8(50.8)	3338.6(49.0)
Tariffs	10.0 %	5.0	23.0	15.0
Canada				
Total imports	692.2	1205.1	1799.3	4289.3
from Asia	30.1(4.3)	27.5(2.3)	62.6(3.5)	19.2(0.4)
PAFTA	479.9(69.2)	672.5(55.8)	1078.3(59.9)	3425.3(79.9)
ROW	182.2(26.5)	505.1(41.9)	658.4(36.6)	844.8(19.7)
Tariffs	10.0	5.0	19.0	12.0
Japan				
Total imports	1470.2	4761.4	389.7	1548.5
from Asia	360.7(24.5)	947.3(19.9)	29.4(7.5)	65.0(4.2)
PAFTA	709.6(48.3)	1317.4(27.7)	138.9(35.6)	707.7(45.7)
ROW	399.9(27.2)	2496.7(52.4)	221.4(56.9)	775.8(50.1)
Tariffs	13.0	5.0	19.0	17.0
Australia				
Total imports	163.0	491.0	957.4	1742.0
from Asia	34.8(21.3)	130.4(26.6)	76.4(8.0)	9.2(0.5)
PAFTA	49.7(30.5)	94.7(19.3)	334.3(34.9)	741.4(42.6)
ROW	78.5(48.2)	265.9(54.1)	546.7(57.1)	991.4(56.9)
Tariffs	15.0	10.0	26.0	19.0
New Zealand				
Total imports	76.0	134.8	252.3	581.6
from Asia	12.8(16.8)	6.7(5.0)	26.7(10.5)	1.8(0.3)
PAFTA	26.8(35.3)	31.3(23.2)	86.3(34.2)	254.7(43.8)
ROW	36.4(47.9)	96.8(71.8)	139.3(55.3)	325.1(55.9)
Tariffs	15.0	10.0	23.0	17.0

* F - Food, R - Raw materials, L - Light manufactures
C - Heavy manufactures

** Asian developing countries

*** mil. US$

**** Shares in total imports.

Source: U.N. Commodity Trade Statistics 1965.

Table 2 The Impact Effects of Preferential Tariff Reduction for Asian Developing Countries*

	F	R	L	C
Increases in total exports of Asia	118.8**(14.7)*** 150.7(18.7)	114.2(7.2) 142.3(8.9)	398.2(45.3) 621.5(70.7)	100.4(32.8) 161.4(52.8)
to U.S.A.	48.7 63.5	33.1 42.2	311.0 484.0	67.0 107.4
Canada	4.0 5.4	1.9 2.5	24.8 39.3	5.0 8.2
Japan	47.4 70.8	62.5 77.6	11.5 18.2	23.2 39.0
Australia	6.3 8.0	15.7 18.8	38.5 60.4	3.6 5.8
New Zealand	2.4 3.0	1.0 1.2	12.4 19.6	0.7 1.0
Increases in total imports of				
U.S.A.	33.3(0.8) 32.2(0.8)	20.5(0.4) 15.2(0.3)	211.4(3.8) 288.2(5.2)	45.5(0.7) 54.6(0.8)
Canada	2.5(0.3) 2.4(0.3)	0.9(0.1) 0.4(0.03)	14.8(0.8) 19.3(1.1)	3.1(0.1) 4.6(0.1)
Japan	37.4(2.5) 45.0(3.1)	32.0(0.7) 21.9(0.5)	6.9(1.8) 9.4(2.4)	13.7(0.9) 20.7(1.3)
Australia	4.0(2.5) 3.8(2.3)	8.2(1.7) 5.4(1.1)	24.0(2.5) 31.4(3.3)	2.2(0.1) 3.0(0.2)
New Zealand	1.5(2.0) 1.4(1.8)	0.6(0.4) 0.3(0.2)	10.9(4.3) 16.5(6.5)	0.6(0.1) 0.7(0.1)
Decreases in exports of				
U.S.A.	11.1(1.1) 15.0(1.5)	7.7(0.5) 14.4(1.0)	9.2(0.8) 18.4(1.5)	5.9(0.1) 6.3(0.1)
Canada	3.6(0.6) 6.0(1.1)	5.1(0.3) 10.5(0.7)	19.0(2.0) 37.7(3.9)	7.2(0.3) 6.1(0.3)
Japan	0.5(0.4) 1.0(0.8)	0.1(0.2) 0.3(0.7)	26.4(1.8) 52.4(3.6)	5.0(0.3) 10.0(0.6)
Australia	2.2(0.8) 3.6(1.3)	3.4(0.6) 6.4(1.2)	0.5(1.0) 1.1(1.9)	0.1(0.05) 0.4(0.2)
New Zealand	0.5(0.6) 0.9(1.2)	0.4(0.4) 1.0(0.9)	0.3(1.5) 0.6(3.1)	0 0.1(0.5)

* Upper figures indicate the estimates with the same elasticities of export supplies of Asian developing countries as those of other exporters and lower figures indicate the estimates with these elasticities halved.

** mil. US$

*** Rates of increases or decreases. (%)

Table 3 The Effects of PAFTA Preferences through an "Advance Cut" : the Case of the United States.

	year	F	R	L	C
Exports of Asian developing Countries	0	364.5*	469.7	683.5	210.3
	1	427.4**	511.0	1159.5	315.4
		412.7	502.1	989.3	276.8
	5	427.0	507.4	1122.5	306.2
		417.2	503.0	1040.0	279.5
	10	421.5	503.8	1085.5	296.5
Exports of other PAFTA members	0	759.7	1500.8	2057.4	3259.2
	1	766.0	1503.8	2072.9	3367.3
		769.0	1508.6	2144.6	3382.3
	5	816.7	1550.3	2627.1	3806.1
		819.9	1554.6	2645.6	3914.4
	10	878.7	1609.4	3270.4	6049.2
Total imports of the United States	0	4010.8	4969.0	5578.7	6807.9
	1	4049.9	4989.9	5954.3	6958.5
		4051.0	4995.3	5879.3	6949.3
	5	4081.3	5010.7	6238.9	7244.0
		4085.6	5026.3	6271.5	7334.6
	10	4113.7	5041.0	6735.7	9314.1

* mil. US$

** Upper figures indicate the estimates with constant elasticities of export supplies of Asian developing countries and lower figures indicate the estimates with increasing values of these elasticities.

COMMENT ON KIYOSHI KOJIMA'S AND IPPEI YAMAZAWA'S PAPER BY SUBROTO

I read Professor Kojima's paper with great interest and I congratulate him on his many original ideas. His paper falls into three sections: an appropriate strategy for dealing with the North-South problem; the character, terms and direction of aid; and the aid cum trade preference suggestion, which is supplemented by the analysis in Mr. Yamazawa's paper.

I shall confine my comments principally to the first two of these three subjects. As I understand him, Professor Kojima favours a global approach to the North-South problem and recognizes the long term importance of the UNCTAD objectives. However, there is a key statement in his paper in which he opts for an intermediate regional approach towards the longer-run global objectives. The question that arises is what is the future of UNCTAD if Professor Kojima's strategy is adopted? Much of our discussion yesterday was focussed on this issue. There appear to be two schools among us: the pessimists who stress the ineffectiveness and irrelevance of the UNCTAD discussions, and the optimists who emphasize that UNCTAD has focussed attention on an important set of problems whether or not it alone can solve them. There does, however, seem to be some presumption in favour of continuing efforts to obtain trade concessions through UNCTAD. For example, although this point was not mentioned in Professor Kojima's paper, there is some scope for narrowing discussion within UNCTAD through the Trade and Development Board. Discussion could also be focussed more effectively in smaller forums within the organization. There are the existing committees (on commodities, shipping, money and finance) which could serve more effectively as agencies through which issues of global importance, to developed and developing countries alike, could be probed.

Perhaps a regional approach, however, offers more promise in the shorter run. There are two issues, in this connection, that appear important. There is the question of coverage and the question of organization. What countries should be included in what regional effort? In our discussions yesterday, at least three possibilities emerged - the advanced and developing countries in the Asian-Pacific region might be included; the advanced countries of the Pacific, with some kind of associated membership for developing Asian countries, could get together; and the advanced countries of the Pacific region alone might constitute the group. The grouping would certainly not depend on strictly economic considerations alone, but would also be determined in part by questions of politics and defense strategy. I, personally, see no objection to the advanced Pacific countries forming some such development and trade organization but I would stress the importance of allowing for the possibility of continued dialogue between the advanced and developing countries in the region. The specific needs of developing countries can then be given more effective expression. In other words, some kind of association could serve a useful economic purpose - and, of course, a useful political purpose. If we concentrate on OPTAD, as a feasible proposition, the big question is whether the United States would participate. PAFTA, as the arguments put forward clearly by Dr. Drysdale and Professor McDougall yesterday suggested, is a very long term and uncertain proposition. As I said, I am not yet clear about the precise form of the organization but it would seem that Dr. Drysdale's idea of a nucleus membership of two or three countries inviting association if desired would be practicable.

As to the character, terms, and direction of aid, Professor Kojima made a useful distinction between direct financial surplus aid and structural adjustment aid. In particular, I appreciate his way of looking at structural adjustment in advanced countries to accommodate the structural transformation of developing countries, and allow the growth of new or stronger export industries. Professor Kojima has clearly drawn on the lessons of Japanese experience in making these bold and imaginative points. My concern is whether other advanced countries can be encouraged to think in the same way. There has always been strong resistance to this kind of thinking by them within UNCTAD. The first problem is to get governments committed to the idea. The next and most important problem is to get the private sectors in advanced countries to accept and engineer the adjustments involved.

Professor Kojima proposed emphasis on three sectors in aid-giving: manufacturing industry, fertilizer production, and cash crops for export. I think his emphasis on the connection between aid-giving and promoting trade expansion is quite original. His recognition of the importance of using aid to encourage the process of structural adjustment towards more effective export competition is useful.

I have very little to say about the trade preferences analysis carried further in Mr. Yamazawa's paper. May I repeat that Professor Kojima's paper is a most challenging exercise. It proceeds three or four steps ahead of policy and should encourage policy-makers to be thinking in the right direction.

COMMENTS ON KIYOSHI KOJIMA'S PAPER BY WILLIAM W.LOCKWOOD

Once more we are indebted to Professor Kojima, our Conference "prime mover," for an imaginative, informative paper on trade, aid and development in the Asia-Pacific region. This time he has combined and up-dated the proposals of his earlier essays[1] in one sweeping Grand Design. If the top planners and administrators of the European Economic Community are known as "Eurocrats," perhaps we may dub Professor Kojima our first "Pacificrat."

His paper proposes sweeping international adjustments through which the developed countries would permit the displacement of their high-cost, labor-intensive industries with expanding imports from the developing countries. These new imports would be more than balanced with their own exports of equipment, chemicals and other products to the developing countries, massively financed for some years with grants and loans. Greater international division of labor along these lines of comparative advantage would raise world incomes and especially would accelerate the growth of the developing countries.

To foster such growth and structural adjustment in the Asia-Pacific region, Professor Kojima renews his proposal for a Pacific Area Free Trade Association (PAFTA) as a practical next step in world trade liberalization. He further urges that the five nations of the PAFTA -- Japan, Australia, New Zealand, Canada and the U.S.--not only reduce barriers in their own mutual trade but also a new set of trade and aid policies directed to the developing countries of Asia. Specifically he calls for trade preferences in favor of developing Asia in both primary products and manufactures, say for 5-10 years. These would be accompanied by a program of loans and subsidies over a similar time period to push through as rapidly as possible the desired structural changes.

In all developed countries government subsidies and controls would be employed to pace and cushion the shift away from uneconomic industries. In the developing countries of Asia, meanwhile, fertilizer grants and equipment loans from the PAFTA nations would be used to expand agriculture, with a view to wiping out Asia's food deficit (now $2 billions a year), and also enlarging cash-crop exports. Other sums would be made available to build new manufac-

1) K.Kojima, "Japan's Interest in the Pacific Trade Expansion", in K.Kojima ed. Pacific Trade and Development, Japan Economic research Center, 1968.

turing industries along lines of comparative advantage.

Examining the pros and cons of trade preferences, Professor Kojima argues that they would be more feasible for the developed countries if combined with two other programs of action: (1) large-scale outlays in foreign aid as suggested above that would serve to boost their exports of heavy equipment and chemicals, and (2) adjustments in the direction of free trade among themselves (within groupings like PAFTA) that would "Jolt" their structures of high-wage protection and thus open the door more readily to new imports from the developing countries as well. Similarly, preferences would be more halpful to the developing countries if accompanied by such foreign aid to expand export capacity in appropriate lines. Without these concurrent programs, he concludes, tariff preferences alone are not likely to have any very substantial effect on the processes of trade and economic development in the Pacific area. The essence of his proposal, then, is this combined approach to trade, aid and development in which the various elements all reinforce each other.

As the Conference has already discussed trade liberalization and preference at some length, I shall pass over Professor Kojima's treatment of this subject, interesting as it is. Let me only express skepticism on one point. Would tariff preferences for developing countries really be more easily achieved if linked with an additional "Joint" to protectionism in developed countries through simultaneous trade liberalization among the latter themselves? For example, would American and Japanese farmers already struggling with fresh competition from Australian and New Zealand farmers be thereby more willing to accept low-cost competion from Asia? Or would Australia take cheap manufactures more readily from Hongkong or Taiwan if already hard pressed by tariff reductions on Japanese goods? The reverse seems more likely; one can hear the argument: "one jolt is enough -- let's not add another." Fortunately, a co-operative approach to Asian aid and trade by the advanced nations of the Pacific does not have to wait upon their adoption of free trade among themselves, itself an unlikely contingency.

In reacting to Professor Kojima's bold scheme for massive structural changes in the Asia-Pacific region I shall address myself mainly to the political feasibility of his proposals for aid. What prospect is there that such sweeping technocratic plans might be related pragmatically to the goals and capabilities of aid donors today? Details aside, the key issues for practical purposes are political will and strategy, on the one hand, and technical and administrative capacities, on the other.

The most feasible component, no doubt, is fertilizer aid and other agricultural assistance to end Asia's food deficit and develop new export potentials in cash crops and minerals. In fact, a major drive to do just this in foodstuffs is already under way with support from major aid donors, further reinforced now by the Asian Development Bank. India, for example, received $100 million in U.S. aid for fertilizer imports in FY 1968, plus the foreign exchange costs of expanding the Trombay fertilizer plan to 500,000 tons capacity, plus loans and risk guarantees from the U.S. government for private plants adding another 360,000 tons of output a year. All in all, India will quadruple fertilizer production from 1966 to 1970, and looks forward to self-sufficiency in the early 70's. A similar expansion is under way in Pakistan and several other countries. Meanwhile dramatic advances are beginning to appear in the field of population control as well. Here Taiwan is leading the way with a reduction in its rate of natural increase from 3.0 to 2.5% in the last four years.

One may hope, them, that substantial reduction of Asia's food deficit is already in progress. The most difficult cases probably are the very big nations, India, China and perhaps Indonesia. Here the sheer scale of the organizational effort required for the appropriate package of resource inputs and technical innovations poses exceptional difficulties. These difficulties are further increased by the fact that foreign aid per capita tends characteristically to run at lower levels in the larger nations. Professor Kojima's proposed $60 million a year in fertilizer aid to Asia over five years does not seem unduly large in this context.

The total aid program in the Kojima proposal for Asia is much larger, however. It calls for one billion dollars a year in outright grants from donor nations for ten years, over and above present aid, and another $1.5 billion a year in private investment to finance plant and equipment in developing Asian industries. How much output or exports could result from outlays of this magnitude Professor Kojima does not say. In any case, these sums are quite fanciful, of course. No such scale of government grants is in sight; indeed, foreign aid is now falling even from its recent modest levels. And not even sweeping risk guarantees by PAFTA governments could possibly bring the quantum jump in foreign private investment he proposes. In addition, domestic capital requirements for infrastructure and supportive industries in recipient countries would be enormous, as would be the foreign exchange needs for maintenance imports. One can only speculate as to the implications for inflation, balance of payments drains, and structural bottlenecks of all sorts.

Even then one suspects that the capital requirements of the projected development might be the easiest to fulfill. Another big component not considered here is that of education, both general and technical. Some Marshall Plan for educational aid far beyond the activities presently incorporated in aid programs seems implicit. Still another implication of the scheme for the developing countries is sweeping new initiatives and controls on the part of government bureaucracies, may of which are already hard put to maintain tolerable levels of efficiency and integrity. Actually the Asian countries growing most rapidly today are those that are moving somewhat away from large-scale State intervention and towards greater reliance on the competitive forces of the market energized by private initiative. In the United States, as well, one wonders how Federal and state agencies could cope with the economic restructuring envisaged in the Kojima plan, on top of the urban decay and rural Appalachias that already afflict us.

These misgivings, however, related mostly to the speed and scale of the transformation proposed by Professor Kojima, not to the goals themselves. They do not touch the validity of his long-term targets of economic integration and growth. They argue only for a more gradual, piecemeal approach.

Any realistic plan of action in foreign aid requires (1) a rational design, relating ends and means in some coherent fashion, (2) a strategy of fulfillment that takes account of linkages and multipliers, and (3) the political motive power to move ahead. Good technocratic blueprints are essential, but so is a sound politico-economic strategy to implement them. Are there political impulses and national-interest calculations that might move us towards the goal in question, even if much more modestly than is proposed here?

On this issue I would dissent from some of the remarks in several Conference papers about the motivations of U.S. aid. If America has put \$125 billion into foreign assistance, including \$30 billion into Asia, it has not been mainly to dispose of surplus goods, nor to satisfy humanitarian impulses, nor even to reap the gains of international division of labor. These considerations have all been present, no doubt. But the driving compulsion has been a concern for the political and military security of the United States. Foreign aid is an arm of foreign policy, directed however imperfectly at helping to build the kind of world in which America and other nations can live in peace and freedom from external threat. It is no accident, of course, nor any economic nor humanitarian calculation, that has put the bulk of U.S. aid at the disposal of nations along the Sino-Soviet frontier. Such allocations will change from year to year, along with the total sums, but the rationale of aid remains geared to these political goals broadly conceived.

For the same reason American aid has not been directed alone to the economic growth of recipient countries. Wider considerations of nation-building enter in, i.e., defense, internal order, social justice, education and other infrastructures of modern society. The achievement is imperfect, of course; there has been plenty of waste and miscalculation. And this has a good deal to do, in turn, with the rising popular mood of discouragement and frustration. The world is intractable; goals often conflict, long- and short-term; and too many people -- in the words of one American business man in Tokyo -- regard the U.S. "as a bottomless pocketbook owned by someone with no problems of his own."

Yet the international aid undertaking in Asia will surely continue, even if at reduced levels. Probably the U.S. and Japan will continue to carry the major burden. The practical task for economic planners, then, is to grasp the opportunities that remain open and decide how best to shape policy towards the end of a more rational, peaceful world order. In agricultural development, as already noted, progress now under way can be accelerated by new agencies like the ADB. In industrial development several countries, notably South Korea and Taiwan, are at last acquiring potentials to attract substantial foreign private capital. In Indonesia the 10-country aid program is setting a new precedent in multilateral action. With the nations of the Pacific supplying the bulk of these resources, such matters might usefully find a place on the agenda of a new Office of Pacific Trade and Development, as proposed by Professor Kojima.

Finally, when the fighting stops in Vietnam, the time will come to embark on large-scale reconstruction of that war-torn country, and to broaden such action to embrace the whole Mekong region. Already ambitious and optimistic plans are taking shape in South Vietnam, as reported by David E. Lilienthal ("Post-war Development in Vietnam," Foreign Affairs, January, 1969). Here, too, an OPTAD might help to break new ground in multilateral action, working through various regional institutions that are now embryonic in Southeast Asia.

To conclude, not only is progress being made, but one sees fresh leads that might be pursued in advancing towards the goals laid out by Professor Kojima. Perhaps another conference on Pacific trade and development is needed to explore more concretely the potentials of immediate joint action by the governments, international business corporations, and educational institutions of the Pacific.

If so, may I add only that it should not overlook the technological needs and political issues of that 40% of developing Asia omitted entirely from our discussion here. I refer especially to China, of course. Here is an intra-Asian gap, a North-South gap, and an East-West gap of crucial significance. Sooner or later China, and the Soviet Union as well, will need to be brought into the orbit of any planning for the future of the Pacific Basin.

Chapter 5

TRADE POLICY - THE CATALYST FOR DEVELOPMENT

H. Edward English

Apart from East-West relations, the most important external challen[ge] to the North Atlantic countries comes from the developing world. We ar[e] at a very dangerous stage in the relationship between the developed and developing world. After twenty years of growing awareness of the difficulties of political and economic development, a feeling of frustratio[n] has arisen in most of the countries of Western Europe and North America. This feeling has emerged from several features of our experience with development and development aid.

In the first place, there is a general attitude arising out of what is called the ineffectiveness of aid, and in particular this is associated with the view that social institutions in the developing countries are not really compatible with the effective absorption of external aid.

A second and related aspect is the experience of frustration of development through population explosion. Western countries have seen GNP rise in many countries of Asia and Latin America, but have seen also much of the benefits associated with this material progress used up in the rapidly rising population.

A third aspect is the weakness or conflict in political regimes. In every part of the developing world, regimes have had difficulty in achieving sufficient political stability to guarantee the acceptance and administration of strong development programs; or even where there have been built up reasonably effective administration, where there has been some agreement on the nature of economic and social planning and a consensus on a particular plan, conflict has entered in to deplete the resources both of administrative talent and finances. Vietnam, Nigeria, the Middle East, India, Pakistan -- all these names are associated not only with efforts at development but with conflict as a major setback in the political and economic evolution of the particular country. Even the great success stories, such as those of South Korea and Taiwan, are regarded as situations of special circumstances. Small countries which have managed to "take off" -- to use the now rather hackneyed terminology -- but have taken off only with such massive aid that if one were to apply on a per capita or any other basis the same aid requirements for other, larger countries, one could not contemplate a real possibility of achieving sustained development by that means.

However, not all the signs are gloomy. There are opportunities for more hopeful development policies in the future. For example, we have learned that capital is not everything in economic and social development and that different kinds of technical assistance are required to create the right conditions for the use of capital in the various developing countries. Often the demand for capital is not really present, because the motivation of people is not toward the effective use of the capital instrument in the direction of economic growth. The most important requirement for many parts of the developing world is now seen to be an upgrading of resources -- improvement of the quality of labour through educatiom and health services and some attack upon those social institutions or aspects of social institutions which remove the motivation for economic growth. Of course, it is still recognized that when one talks about attacking social institutions in order to achieve economic growth, one immediately raises the question as to whether development itself is not a serious intervention into the developing country's social preference patterns, and one must get down to the fundamental issue as to whether development is really wanted. Assuming, however, that it is wanted, technical assistance in all its varied forms has become the top priority. A second lesson has been learned largely by the developing countries themselves during the postwar world. This is their discovery that planning is not everything and that, indeed, the market economy can help to reduce the work of the planner--can not only discipline the planner himself, but serve as a discipline upon the private elements in the economy which enables the planner to devote his energies to top priority public intervention. Related to the discovery that planning is something that should be used in small doses before it is used too comprehensively is the discovery that foreign private capital may bring a helpful package of aid to development.

To tie together some of this thinking, I suppose one could conclude that there has been a growing recognition of the nature of the development program required for the future. A balanced program incorporating at least three main ingredients: first, appropriate policies by the recipient country. I mean by that a set of policies which will make the best use both of domestic resources and of any resources that can be made available from external sources. The recipient country should be able to choose its policy program without having to limit its growth projects on grounds that an inadequate amount of foreign capital is available. Of course, in any one year there are limits to the amount of foreign resources that a country can expect to obtain. But it should not have to place balance of payments considerations at the top of its list of constraints upon development planning. Balance of payments considerations ought to be secondary to determination as to reasonable growth targets and the most appropriate allocations of resources to achieve these targets in areas with maximum growth potential. It is not, of course, easy to apply this kind of criterion, but it certainly must be hoped that we have come some distance from the simplistic view that the secret of development is in the movement of resources into manufacturing industries, out of agriculture, and that we have to give hostages at all points to status symbols such as airlines and steel mills. One of the greatest problems in this connection lies in the ability of political leaders of developing countries to carry with them the majorities in their population, when those majorities may not have the political sophistication to recognize the costliness of status symbols. And related to this challenge to the political leadership is the problem of just how the donor countries can best contribute policy advice to the developing countries. Clearly, some of the aid programs of the past, especially the bilateral aid programs, have involved real difficulties so far as the giving of advice is concerned. Sensitivity on the part of developing countries when the donor country ties any string - or appears to tie any string - to aid is understandable, but it is a costly kind of sensitivity when and if the donor country could be giving useful advice as to the most efficient application of aid. This brings me to the second major component of <u>a balanced development program, the opportunity for trade</u>.

One of the striking developments of the last four or five years has been the realization by the developing countries themselves that trade can play a much bigger role in development. Of course, the issue this poses is how to reduce the trade barriers and stimulate the flow of exports from the developing country. Much of what I have to say in the rest of this talk relates to this question, so I will postpone further discussion until I have introduced at least the third element in a development program.

The third element is, of course, aid itself. I put it last because I think the view of aid now is that aid is the residual factor -- the factor that must be brought in to provide the missing resources. Resources that are missing in the sense that without those resources development would be made more difficult, because development would generate the kind of fundamental balance of payments difficulties which would make it much more expensive for a developing country to achieve the desired advance. To round out, then, the balanced development program requires a policy program for the recipient country, an opportunity for trade, and aid programs to make possible the effective operation of the first two factors.

I think that the question of trade has become important both economically and politically. We must recognize that, although it has been possible in the past and it might be possible in the future, at least on the lines of economic argument, to argue that massive aid would solve all problems (this is the position adopted by a few American economists), it is really unrealistic to think of aid being achieved by the "massive aid" route. Economically, the great importance of trade lies in the contribution it makes to efficiency in development. Not only does it enable the developing country to specialize, to assign the resources to lines of productive activity which are likely to produce the greatest returns, and also to import those goods which it is not economically wise for them to produce; but trade also introduces competitiveness into development, which can make an important contribution to the motivation and the managerial sharpness of those who are producing in the developing countries. And I might add that this should apply whether those producers and managers are operating in publicly owned or privately owned enterprises. On the political side, the contribution that trade opportunities can make to the development process arises out of the problem of efficiency also. If trade is contributing to a more efficient use of aid and investment activity, then the disillusionment which has arisen in the past out of the failures of aid and investment programs may begin to disappear. Furthermore, and this is a point that is seldom stressed, trade concessions on the part of developed countries give those countries a stronger bargaining position in respect to the developing countries. It is much easier for a trading partner who is making a concession to ask for changes on the part of the other trading partner in his domestic policies as well as in his trading policies than it is for the same trading partner to demand or expect concessions if he happens to be a donor of aid. I am convinced that we must begin to think big in trade policy; we in the developed world must contemplate a generalization of unilateral free access for the developing countries' exports. Unless we do this, I think we will not be able to turn the tide in a favourable direction in respect of aid, and we will not be making the contribution expected of us to efficiency in development.

So there are two necessary ingredients if a massive trade policy program is to have much chance of success. First, as I have already implied, if trade is to be effective as a contributor to the development process, it must be a part of a balanced program which I will, for the purposes of illustration, call "regional development schemes."

If I may be permitted to digress a moment, I think it is ironic that major countries such as the United States, who have always regarded the security question as appropriate for regional treatment, should have generally stayed away from the contemplation of regionalism in the trade field. It is not hard to see why, historically, because there might have been some concern about a regional approach to trade liberalization, but I think that a tendency to persist in the antipathy to regionalism in trade reflects rather a lack of willingness to contemplate new policies for new situations.

The elements of any regional development scheme should, I believe, include the following. First, the less developed countries should be given free access to the markets of the developing countries, either generally, if that is possible, or, if it is impossible at first, on a regional basis. Secondly, the less developed countries should be encouraged to form free trade associations or, if they wish, customs unions in their regions. Third, the less developed countries should be encouraged to reduce their external tariff, or at least bind it against increases with an expression of intent to review and reduce it at some specified time in the future. The purpose of this is not merely to allow for the possibility that they will become developed and no longer need their protection, but also to ensure that they do not divert resources from their most effective uses by retaining ridiculously high levels of protection. Fourthly, the less developed countries should be encouraged to work out a domestic policy program which will assist the specialization of their industries in the direction implied by the free trade grouping and unilateral access to developed country markets. And finally, fifth, the developed countries should offer aid and guaranteed private investment on a basis which will help to ensure that balance of payments problems will not frustrate the working out of the benefits of the trade and development scheme.

Now all these components of a regional development scheme should, of course, be working together. The thing that distinguishes this concept from previous development ideas is the stress given to the trade component. I want to emphasize that none of us who look at the economics of development should have any illusions about the rate at which the developing countries can become major exporters, particularly of manufactures, to the developed world. And I think very often the failure to place adequate importance on the trade question has arisen from the feeling that trade would not greatly improve the balance of payments situation of the developing countries in the short run. Of course it won't. In economic terms, the supply elasticities of these countries are not going to be high in the short run. But what is important is that the adoption of liberal trade policies by the developed countries and the encouragement of more attention to trading opportunities in the developing countries will direct the attention of those countries to their most promising development opportunities, assuming, of course, that domestic policy will not frustrate this international market discipline.

I said a little while ago that there were two necessary ingredients for trade to make its most important contribution to economic development. One of these is the need for a regional development scheme. The second, I think, is the need for joint action by the developed countries themselves. The developed countries -- in the largest sense -- the Atlantic community plus Japan, Australia, and New Zealand -- this group of countries can make progress toward unilateral free access needed by the developing world only if it is prepared to act in a coordinated and cooperative fashion. I think it very hard to imagine any one country, even a major country, offering free access alone. We see in the European experience the relationship of the EEC to the former French colonies in Africa an example of the way in which free access, of a limited sort to be sure, was given to a group of developing countries as a feature of the establishment of the Common Market. I think the politics and the situation of the world more generally suggest a similiar, though perhaps more ambitious, approach, using the same principles. There is a real opportunity for, let us say, the United States to initiate a regional development scheme by calling upon other members of the developed world to participate both in making these major trade concessions and aid contributions to the developing world.

To be more specific, the formation of an open-ended free trade association amongst the developed countries could give them the kind of mutual exchange advantages which will increase their own income, and thus their ability to give aid. A number of the estimates of the benefits of complete free trade to developed countries have indicated that the size of the gains from free trade would be in the order of perhaps one percent of GNP (larger for certain countries, such as Canada, Australia, and possibly Japan). This one percent of GNP looks small, but it is, of course, the aim of the developing countries, the familiar measure of the aid contribution they wanted from the developed world. Surely it would be a significant factor, given the levels of aid already achieved, even if half of the gains from trade could be made available to the development process. In the long run, of course, the income implications for both developed and develping countries would be much larger than the initial and static measurement of gains from trade implied.

Among the developed countries, the larger countries such as the United States would, of course, have a primarily political motivation for initiating any development scheme based upon mutual cooperation and free trade association amongst the developed countries. For the smaller countries, of course, the stimulus to participate would be greater. In Canada, for example, where there are much more benefits to be derived from trade liberalization -- more gains from trade to be realized -- the opportunity for participation in a free trade association involving the United States and other developed countries would present an exciting potential for the realization of more efficient industry and more specialized lines of economic development in manufacturing in this country. It is difficult to imagine any alternative trade policy which could produce equivalent benefits for the Canadian economy.

The major responsibility of the developed countries is to minimize discrimination in trade, while at the same time making as large as possible a contribution to economic development. The ways in which this can be done may be varied, but I find it difficult to contemplate any method more likely of success than the one I have indicated: namely, first an open-ended free trade association, open to all the developed countries; second, a wide application of the regional development scheme concept; and third, negotiations under GATT to bring down whatever barriers remain between regional groups. (I might also add that a fourth need is to devise ways of increasing trade between the East and the West, insofar as it remains difficult for the Eastern European countries to participate in the free trade association approach.)

Now, finally, what are the prospects for this approach to trade and development? First of all, let me say that in Latin America and in Southeast Asia there are very real possibilities for this kind of approach. We must remember that the Latin American themselves have adopted in principle the concept of a free trade association, or even customs union, in the whole of Latin America. In Southeast Asia, while they have not proposed formally any such association, it is considered quite possible that regional development schemes based upon the existing regional institutions of that part of the world could be extended to trade policy arrangements. The Japanese have shown an interest in such an arrangement. The areas in which the application of regional development schemes of the kind I have been talking about would prove more difficult are South Asia and Africa. In the case of South Asia, the size of the development problem in India and

Pakistan is such that it would certainly be necessary for a very large number of developed countries to cooperate. The ideal, at least before Czechoslovakia and Vietnam had interfered with detente, would have been a development scheme involving the United States and Japan and the Soviet Union, with such European cooperation as might have been forthcoming. The Soviet Union could participate in a South Asia development scheme by making generous commitments to import the kind of products exported to other developed countries. However, I will not speculate more now on this rather remote possibility.

In Africa, the problem is of course quite different because the countries of Africa have so recently achieved political independence, and in so many cases still have to achieve a measure of political maturity that would enable them to accept such limitations on thier sovereignty as are implicit in the notion of regional free trade areas. But I am wondering how far away such projects really are from reality. In East Africa, for example, the regional free trade arrangement between Tanzania, Uganda, and Kenya has survived the difficulties which closer integration efforts have experienced. And it should be, over the years, increasingly possible for the very small countries of West Africa to see that they could achieve economic benefits by integration, while at the same time retaining the essential element of their political independence.

Well, these are very big, far-reaching, and we probably should also say presumptuous, ideas about the possible course of future development and the role that the Atlantic countries might play. One can conclude that it is all highly unrealistic and that the world is a much less promising place than these kinds of schemes imply it can be. I think I would have to end, however, by saying that unless we are prepared to make major steps, either as individual or small groups of Atlantic countries, or more hopefully as a whole, toward the solution of the great development problem, we are going to be confronted with the danger of conflict and of grass root chaos which would make the story of Biafra so general as to be terrifying.

DISCUSSION OF PAPERS PRESENTED BY B. W. WILKINSON, K. KOJIMA AND I. YAMAZAWA, AND H. E. ENGLISH

In reply to comments on his paper, Professor Wilkinson thanked Professor Johnson not only for raising the important questions about the techniques of analysis he had used but also for providing many of the answers to those questions. He wondered whether it were true, as Professor McDougall had suggested, that analysis of the effects of integration based upon existing trade patterns was largely an irrelevant exercise for countries like Canada, Australia, and New Zealand, because of the overwhelming importance of other, dynamic, effects. He thought that the important things in trade competitiveness, and the established patterns of trading, were market connections and who had taken the initiative in international marketing. This appeared true also where the possibility of scale economies exists. In that case, analysis based on existing trade structures might be more relevant than it seems at first sight.

Professor Wilkinson said that in his elasticity estimates for agricultural exports from New Zealand, he had relied heavily on work published recently by Turnovsky which sets the aggregate elasticity of demand for New Zealand's exports between 0.6 and 0.8.

Professor Wilkinson went on to suggest that the terms of trade loss in real income for the increased-trade-deficit countries may not turn out to be the most important factor. On this point, the Wonnacott study for Canada is illuminating. The Wonnacotts estimated that gains due to the realization of economies of scale, lower consumer prices, and productivity increases might amount to 10% of G.N.P. However, the Wonnacott study may have been a little too optimistic about the effects of free trade on industrial location. Other studies by the Canadian government indicate that, despite certain cost advantages deriving from location in Canada, free trade in North America might induce American firms previously operating in Canada to re-locate closer to the final market in the States. The effects on location in Australia and New Zealand could be expected to be quite different because of the distance factor and other marketing factors.

In reply to comments on his paper, Professor Kojima confessed that he had taken a deliberately extreme position in putting forward his proposals but pleaded academic privilege. He argued that it was important to think about the ultimate structure of world trade, and to try to visualize the adjustments that would be necessary if developing countries were to fit into it. He agreed that the nature of structural adjustment, both from the viewpoints of government planning and private business planning, requires future study. But he re-asserted that the jolt of structural adjustment resulting from reciprocated trade concessions among advanced countries should make it easier to make room in advanced country markets for imports from developing countries.

Professor Kojima also agreed that UNCTAD had played a useful propagandist role in encouraging a more positive approach to trade policies towards developing nations. But he believed that in order to solve the more urgent problems, it would be necessary to adopt a regional approach to trade and development policy. Developing countries comprise a heterogeneous group, at different stages of development, with different interests in different places. Whilst fully recognising the dangers of being accused of excessive paternalism, of fostering over-dependence, or of neo-imperialism, he remained convinced that a regional approach was the most promising. He maintained that his proposals were feasible in principle. The real question was who should start the ball rolling? The United States now appears hesitant. Why not Japan? It would, of course, be preferable if Japan could join with a group of advanced countries for the purpose of initiating these new development policies.

Discussion of Professor Wilkinson's paper centered on certain technical aspects of his estimation procedures and the effect they had on his estimates. Discussion of Professor Kojima's and Mr. Yamazawa's paper centered on the question of whether it was wise to combine moves towards freer trade among advanced countries with the extension of trade concessions and economic assistance towards developing countries.

Attention was drawn to two biases in Professor Wilkinson's estimation procedures, both of which adversely affected his measurement of the export response from Australia and New Zealand. A New Zealand participant questioned the relevance of Turnovsky's elasticity estimates, referring to estimates of the elasticity of demand for Australian wool made by Horner. More recent studies by the Australian Bureau of Agricultural Economics also put the price elasticity of demand in excess of 1.0. Another participant argued that the growth of competition from synthetics was likely to have increased the price elasticity of demand for wool from Australia and New Zealand. An Australian participant pointed to the bias in estimation which resulted from no account having been taken of non-tariff trade barriers, which were of special significance for agricultural exports to Japan and the United States. For example, the tariff on meat imports into Japan is 10%, but the tariff equivalent of import restrictions is probably in the order of 200 or 300%. This divergence is typical over the whole range of agricultural commodities of importance in the export structures of Australia and New Zealand. Incorporation of the effect of quantitative restrictions into the analysis would, it was suggested, make a tremendous difference to estimates of the balance of trade effects of a free trade area on these two countries.

Another participant was concerned about the " neo-mercantilist " emphasis in estimates of the effects of the formation of a free trade area. He said that it was surely important to calculate the welfare effects of these changes in the aggregate value of trade in order to assess precisely the benefits of a free trade area. Professor Wilkinson accepted this comment as fair, and went on to point out that the exercise should really consist of three parts - calculation of the static trade effects, calculation of the welfare effects deriving from the static trade effects, and calculation of the welfare effects deriving from dynamic changes. He added that it was common to assume familiarity with the literature and go on from there - although perhaps this assumption was unjustified in public discussion.

There was also some discussion of the adjustment problem resulting from the freeing of areal trade. Professor Johnson argued that it was reasonable to assume that the adjustments would take care of themselves since the changes in tariffs, etc. would be implemented over a longish period of time.. Others were concerned about short-run balance of payments problems, or problems of structural unemployment, during the adjustment period.

An American participant wondered whether transport costs across the Pacific contributed an obstacle to the free trade area. Others pointed out that it was generally cheaper to transport bulk commodities across the Pacific than across the American or European continents and that the trends in transport technology increasingly favored sea transport.

In discussion of Professor Kojima's paper, the logic of combining a move towards the establishment of a free trade area with the extension of trade preferences and economic assistance for developing countries was queried. One participant said that he understood that the reason for combining the two operations was that adjustment had to be made in both directions at the same time. But he said that this need not mean that a free trade area was a necessary prerequisite for the extension of trade preferences. He was also concerned about the possibility of over-dependence on, and charges of imperialism against, particular advanced countries. Participants from developing countries were not concerned about that problem, especially if there were associations between a group of advanced countries, and a group of developing countries. One referred to the growing maturity of developing country nationalism. A new generation of national leaders had now succeeded the old post-colonial generation in Asia, and their attitude was more permissive of advanced country involvement in the economic development of their peoples. The danger of compartmentalisation, referred to in UNCTAD, might be overcome by regional in place of bilateral connections between developed and less developed countries.

Other participants stressed the role of technological transfer in the development process. It was felt that there might be some scope for the foundation of a regional institution, similar to the IRRI, which specialized in the adaptation and dissemination of technology for use in light manufacturing industries.

Part III

ALTERNATIVE POLICIES FOR ECONOMIC COOPERATION AMONG ADVANCED PACIFIC COUNTRIES AND ASIAN DEVELOPING COUNTRIES

Chapter 6

Alternative Policies in Trade Cooperation of the Advanced Pacific Countries in the next Five Years

L. V. Castle

I Introduction

At the first Conference on Pacific trade and development in Tokyo last January we ranged fairly widely over many of the issues that are involved in extending the degree of economic cooperation among the advanced countries of the Pacific Basin. Although our attention was focussed on this question and on its relationship to that of assisting the developing economies of the area there was a general consensus that Pacific economic cooperation even if confined to Japan, Australia and New Zealand could not logically be pursued in isolation from the main stream of thought and action in the world at large about trade and aid policies in general.

Any discussion of alternative policies in trade cooperation among the advanced Pacific countries therefore really needs to be preceded by some view of these broader issues. These are, however, touched on only briefly in this paper because they are to be dealt with more fully in the papers by Dr. Sperry Lea and Professor Johnson. In addition, during the past twelve months a number of important papers have been published, especially those under the auspices of the Atlantic Trade Study, which have contributed much to thinking about the development of world trade and aid policies. Again since some of the alternatives in trade cooperation are the subject of separate papers I shall not attempt to cover the same ground but will approach the subject with a view primarily arriving at some assessment of what seems desirable directions of policy and of what seems politically possible to achieve or at least to set in train among some or all of the advanced Pacific countries in the next five years.

In summary, the position taken in the paper is that it is unrealistic to envisage within that time the establishment of any trading regime among the five countries concerned which involves discrimination against non-members; and further that even if conceived as a longer term, though intermediate, goal on the way to world free trade would need to follow rather than precede a free trade arrangement centred on the North Atlantic where the more important economic interests of two of the suggested members, Canada and the

United States, presently lie. This indeed amounts to no more than agreement with the view advanced by Professor Johnson in his paper and summary of discussion[1] last year on which there appeared to be a general consensus among the participants.

The main part of the paper is concerned with other suggestions that have been made from time to time for the conclusion of special trading arrangements within the more limited circle of Japan, Australia and New Zealand. Again, the view taken is one of doubt about the desirability of such steps (especially as far as a customs union or free trade area of general or restricted scope is concerned) and that, even if desirable, a considerable amount of groundwork needs to be done before the parties are likely to be willing to come to the negotiating table. An alternative and less rigorous association is suggested as a practical step, building on the institutional arrangements which already exist, and providing a framework within which particular deliberate efforts might be made to remove obstacles to the development of more far-reaching arrangements in trade cooperation, such as a general free trade area. It is suggested too that United States and Canadian membership would be possible in such a flexible type of association without conflicting with their North Atlantic trade interests or the development of a global trade strategy.

II World Trade Policy

Although there remain important areas in which only a modest degree of liberalisation has been secured, or worse still where restrictions have been increased, the achievements over the past twenty years in reducing trade barriers are undoubtedly impressive. Much of this has occurred under the aegis of GATT through successive rounds of tariff negotiations and through the pressure brought to bear in that forum against non-tariff trade barriers. In addition, however, the past ten years has seen the formation of the E.E.C. and the E.F.T.A., both of which add substantially to the area over which free trade or virtually free trade is a fact of life. The tariff reductions negotiated in the Kennedy Round, although in many cases less than had earlier been hoped for, must

(1) "Pacific Trade and Development" Papers and Proceedings, ed. K. Kojima, J.E.R.C. February, 1968.

be regarded as a major achievement, not simply as a general tariff-cutting exercise, but, when the reductions come fully into force, as significantly weakening the discriminatory effects of European regional integration.

All of these developments make it possible now to postulate world free trade as a major policy objective, whereas twenty years or even ten years ago this must have been dismissed as an idle dream. As an objective it is relevant, not only to the industrialised countries of Europe, North America and Japan, but also to the developing economies in which there appears to be dawning realisation that policies of protectionism and of manufacturing development based on import substitution are likely to retard rather than promote their economic growth. This is true also of New Zealand, which in the past has made extensive use of import quotas as a means of fostering industrial development, but is now moving slowly towards a more liberal industrial policy in which the emphasis is on export development, international competitiveness and comparative advantage rather than on import substitution in a small domestic market and on manufacturing development almost for its own sake.

Though a conceivable objective, world free trade is nevertheless a long way off; but it has a significance even at the present time as an organising principle or frame of reference in the development of new trade policy initiatives. The concept of a N.A.F.T.A. as an open-ended free trade area which any country might join is certainly consistent with that principle if the removal of tariffs is accompanied by a set rules designed to ensure reasonable equality of opportunity to benefit. But a NAFTA which excludes Japan or any developing country because of fears of strong competition in certain politically sensitive areas of manufacturing or excludes agricultural products (thus effectively denying Australia and New Zealand the opportunity of participation) is not consistent. Indeed, a NAFTA of this kind would not be addressing itself to its main rationale, namely as a means of handling the urgent problem of providing full opportunities for the developing countries to expand their exports of primary products and manufactured goods to the developed countries, an essential requirement, along with an adequate aid programe, if their economic growth is to be promoted. This the Kennedy Round failed to do. There is a danger that unless any initiative is viewed as a step toward the ultimate goal, the easier parth of ignoring agriculture and the developing countries' problems would be taken. Whatever justification that course might have in terms of strengthening the industrialised economies of the North Atlantic and the political cohesion of that part of the world, it would amount to turning aside from the main political problem of our time, relations between North and South. Thus, the approach suggested is that the focus of attention should be on these Kennedy Round residual problems - agriculture, market access for developing countries and non-tariff barriers - allowing a NAFTA or any of the other initiatives suggested for example by Professor Johnson (2) to emerge as instruments for dealing with them through a mutual sharing of the burdens of readjustment that would be required of the industrialised nations. It is not of course suggested that any new approach to trade policy should be judged solely by the criterion of how effective it might be in dealing with the problems of the developing countries. One cannot reasonably expect altruism of such an order. But unless these problems are accepted as an integral part of any new negotiation, there is the danger that, as in the Kennedy Round, these difficult issues will go on being put to one side in spite of initial declarations that they would not. Compromise of this kind is virtual failure. No bread is sometimes better than half of the wrong loaf.

The prospects of using a move toward North Atlantic free trade as a means of resolving these problems depends crucially upon the United States, although the policies of European countries are also relevant. There is no sign, however, that the United States is ready to contemplate a major initiative of this sort; indeed the signs all seem to point to a standstill for some years ahead. The Kennedy Round tariff reductions are to come into force over a period of five years. In the light of the resurgence of domestic protectionist forces it would not be unexpected if the new United States Administration were to prefer to delay any major new moves toward freer trade until the domestic political repercussions are more clearly seen. Moreover, there are the pressing probleme of the United States balance of payments and the continued international stability of the dollar both of which place severe constraints on what the United States may be willing to contemplate. In any event a new initiative could not be taken except in concert with main trading partners - in particular Canada and the United Kingdom and probab-

(2) "World Trade Policy in the Post-Kennedy Round Era": Economic Record, June, 1968.

ly also the EEC. The United Kingdom position is still firmly that of joining the EEC and despite continuing rebuff, it does not seem likely that in the next few years she will reverse that policy and look across the Atlantic for an alternative to the wider trading partnership which, primarily for political reasons, she seeks in Europe.

The political, military and economic interests of the United States being mainly Atlantic-centred impose an obvious further constraint on what policies can be adopted in other areas of the world. Given the difficulties that already exist about the level of some Japanese imports into the United States and comparing the relative importance of Japan, Australia and New Zealand as trade partners with the North Atlantic countries, it is hardly conceivable that the United States would be willing to enter into a free trade relationship in the Pacific while not prepared to do so in the North Atlantic. In addition, Pacific free trade would require discrimination against Europe, an outcome which would be contrary to the major policy of maintaining a strong political and military alliance with that region. On the other hand, it would not be in United States interests in the Pacific to have discrimination against Japan. Thus while new trade policy initiatives must be centred on the Atlantic, it would be important that Japan either be included in any negotiations - the most desirable course since the burden of adjustment would not then rest solely with the United States - or a subsequent negotiation with Japan would be necessary to provide equal access with Europe to the United States market.

III Japan-Australia-New Zealand Trade Co-operation

The obstacles to any early establishment of a Pacific Area Free Trade Agreement have re-awakened interest in the possibility of closer economic integration among Japan, Australia and New Zealand. Since this topic is the subject of papers by Dr. Drysdale and Professor McDougall only some general observations are made here.

On the face of it the idea seems attractive. Trade between the three countries has in recent years grown faster than with any other trading partners. In the case of Australia, Japan is now that country's most important single market taking some 21% of

Australian exports in 1968 compared with 4% in 1950. Exports to Japan consist overwhelmingly of wool, other agricultural raw materials, minerals and fuels and foodstuffs. On the import side, Japan is much less important as a source of supply, providing only 10% in 1968 although this was a marked change from the share of 1% in 1950. The composition of imports is almost the reverse of the export pattern, with metal manufactures, chemicals, machinery and transport equipment and textiles comprising 94% of the total. This high degree of complementarity is true also of Japan/New Zealand trade. Exports of New Zealand to Japan consist mainly of meat, wool, dairy products and forest products but like Australia imports are nearly all in the categories of machinery, textiles, manufacturers raw materials and components, chemicals and other heavy industrial goods. The importance of Japan as a trade partner is less marked than is the case with Australia, Japan taking 9% of exports and providing 6% of imports in the year ended September 1968. The main reason lies in the different nature of the two countries export structure. Raw materials and minerals from Australia are not subject to import barriers in Japan whereas these have been a major handicap to the expansion of foodstuffs exports from New Zealand. Furthermore, Australia has pursued a policy of market diversification toward the Pacific much more vigorously than has New Zealand which retains (there is no real alternative at present) strong trading links with the United Kingdom.

Two possible forms of economic integration between the three countries have been suggested, a customs union and a free trade area of general or limited scope i.e. sectoral integration. If anything, the free trade area approach is clearly preferable. A customs union requires agreement on a common external tariff which would be almost impossible to negotiate. The existence of a preferential tariff system in favour of the United Kingdom and other Commonwealth countries is a major difficulty; but a customs union also implies a much greater identity of cultural background, foreign policy objectives and external trade and economic relationships among other things, than exists among the three. A customs union between Australia and New Zealand on the other hand would be much more practicable, (indeed the idea of full political union between the two has been advocated from time to time) but there is as yet insufficient perceived identity of interest to make it a proposition worth pursuing.

A free trade area on the other hand is a much more flexible instrument, with each party left free to determine its own relations with non-members. Moreover, it can more readily accommodate new members or fit into any more comprehensive arrangement that might eventually be negotiated among other countries with which the members have strong trading links. The benefits and costs of a free trade area between the three countries have nevertheless yet to be adequately assessed. Given the nature of each of the three economies one might expect that Australia and New Zealand would benefit from a more rational and specialised development of their manufacturing industries and also from much better access to the Japanese market for agricultural products. Japan for her part would gain from the elimination of high cost agricultural production and from better access for her industrial products to the Australian and New Zealand markets.(3) A free trade area would effectively require, however, the elimination of the present Commonwealth preferences which are bound to the United Kingdom in terms of trade agreements with that country. In addition to the contractual preferences accorded the United Kingdom, both countries accord non-contractual preferences which in the case of New Zealand commonly range around 12½% - 15% in addition to the average contractual margin of about 10%. In some important cases such as motorcars and machinery the non-contractual margin is in excess of 30%. Elimination of these contractual and non-contractual preferences would almost certainly result in a substantial diversion of import trade away from the United Kingdom, especially in the case of New Zealand. Both countries must therefore assume that the preferential treatment accorded their exports to the United Kingdom would be withdrawn. This might not be of great concern for most exports as regards preferential tariff treatment in the United Kingdom, but the withdrawal of the present guarantees of freedom of access for meat and dairy produce could open the way for the imposition of quotas by the United Kingdom for the protection of its farmers. Nor could New Zealand and Australia expect the United Kingdom to take or to maintain the present measures to protect their exports against dumping from other countries. The loss of these privileges would not follow automatically even if the trade agreements were to be abandoned since the United Kindom is unable to supply her own requirements. But it is to the United

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(3) For a fuller discussion see I.A.McDougall, "The Prospects of the Economic Integration of Japan, Australia and New Zealand" in K.Kojima (ed.) "Papers and Proceedings of a Conference on Pacific Trade and Development" J.E.R.C. Tokyo, February 1968.

Kingdom's advantage to accept the cheapest supplies offering, regardless of whether or not they are dumped or subsidised. Withdrawal of her preferential tariff advantages in Australia and New Zealand in favour of Japan would encourage her to do so.

However, this problem only applies to dairy produce, which constitutes a very small part of Australia's exports and while a greater proportion in New Zealand's case are of declining importance. Also the current discussions in Geneva on the dairy produce problem seem likely to be successful in establishing some order in the trade under a system of minimum export prices coupled with a programme of food aid. For these reasons the withdrawal of British preferences may not entail unacceptable retaliation by Britain, which would at least retain preferential advantages over all non-Commonwealth countries other than Japan.

But a free trade arrangement would also mean the elimination of the preferential position which Australia and New Zealand enjoy in each others' markets, both in terms of Commonwealth preference and in terms of the Australia-New Zealand Free Trade Area Agreement concluded in 1965. If that were to happen (and a JANFTA would not make much sense unless it did), Australia would face serious competition from Japan in the New Zealand market. Although exports to New Zealand amount to only 6% of Australia's total exports, nearly all of these are manufactured goods. Indeed, New Zealand is Australia's principal market for these products. The converse also applies. New Zealand has its main market for manufactured goods is Australia and would not relish the prospect of Japanese competition in that market under a free trade regime. Manufactured goods form only about 10% of New Zealand's total exports, but they have been growing very rapidly in the last few years - over 80% in the last twelve months. The target is that they should expand by nearly 450% between 1966/67 and 1977/78, as a necessary element in achieving a growth rate of 4% in Gross National Product and as part of the policy of reducing New Zealand's dependence on exports of agricultural produce.

It does not necessarily follow, however, that Japanese free trade competition would seriously reduce Australia/New Zealand trade in manufactured goods. Many of the commodities exported by New Zealand such as carpets, processed foodstuffs, machinery and forest products, are exported to other markets as well, where they do not receive preferential tariff advantages. The same may be said of Australia.

Other factors, Such as strong connections between Australian and New Zealand business firms and the availability of regular transport services, especially by air, would also act as non-tariff advantages in favour of Australia and New Zealand in this type of trade. Nevertheless, the possibility of trade diversion in this area as a result of the formation of a JANFTA requires to be examined in assessing the overall advantages and disadvantages of such a policy move. It may, of course, be argued that the present pattern of Australian and New Zealand trade in manufactured goods is not immutable, and that with the re-structuring of Australian and New Zealand industry, the development of greater industrial specialisation, especially through a free trade area with Japan, would lead to a more firmly based structure of manufactured exports than is the case at present. But this is not an argument that is likely to have much appeal to policy makers a priori.

A JANFTA would also discriminate strongly against the United States and Canada. The United States provides about 20% of New Zealand's imports and about 26% of Australia's, as compared with 9% and 10% respectively in the case of Japan. On the face of it, there would appear to be the likelihood of very serious trade diversion away from the United States towards Japan. This may be an important gain for Japan, but one may presume that since both countries now compete on equal terms tariff-wise in the Australian and New Zealand market, these latter countries are likely to lose through diversion to higher cost imports. This is also a problem requiring detailed study, in order to gain a view of their possible quantitative significance. Consideration of the above points raises a more general issue. Although the trade links between the three countries are yearly growing more important, each still retains major trade connections with third countries. In the case of both Australia and New Zealand, the United Kingdom, the United States and Western Europe (all of whom are likely to be affected by preferential treatment for Japan) are collectively more important as sources of imports and as export markets than is Japan, and in each of these markets export prospects are likely to depend in the future less on tariffs than on policy decisions about protection afforded to agriculture. So the question they must face is whether, by affording preferential treatment to Japan, they undermine the moves towards containing agricultural protection in Europe and

North America and effectively scotch the chances of bringing agricultural products under an agreed and reasonable set of international trade rules. This point deserves more attention than it has so far received in our discussions on Pacific free trade.

A free trade area between Japan, Australia and New Zealand is really justifiable only if it is conceived as a means of expanding trade, although in a limited area, in advance of a North Atlantic initiative, or as a means of making it easier in the longer run for Australia and New Zealand, still highly protectionist, to participate. (A subsidiary justification is as a response to their exclusion from a NAFTA; but while it may be the best policy in those circumstances, it would certainly not be an ideal outcome, either for the three countries or for the members of an exclusive North Atlantic club). The interests of each of the three countries are in maximising their economic growth through trade and the efficient use of their resources, and they can do this better by trading freely with the whole world rather than by channelling their trade to a few by means of discriminatory tariffs or other trade restrictions. This is especially relevant to New Zealand and Australia as major exporters of temperate agricultural products, because it is only within a world framework that the problems of trade in these products are likely to be capable of solution. Japan, too, would clearly prefer to have freedom of trade on a world basis. As Professor Kojima has noted, "the best choice for Japan is to expand and free mutual trade with every trading region. The present stage of her industrialisation, her dual pattern of trade with developed and developing countries, and her geographical location, dictate such a choice." (4)

The expansion of Japanese exports at a rate of about 10% per annum is essential if she is to maintain her present rate of economic growth. Thus, because of the increasing importance of Japan as a market for their foodstuffs, raw materials, and minerals, it is in the interests of Australia and New Zealand that through the freest possible access to overseas markets Japan is enabled to achieve the desired rate of export expansion. According Japan an exclusive position in the Australian and New Zealand markets, while it may lead to an increase in her exports to those countries at the expense of third parties, would weaken the incentive for those countries to

(4) Kiyoshi Kojima: "Japan's Interest in the Pacific Trade Expansion" in K.Kojima (ed.) op. cit. p.169-170

reduce barriers to Japanese imports.

The negotiability of a free trade area among the three countries faces two main problems. First, the existing Japanese policies of agricultural protection (the inclusion of agricultural products would be a sine qua non for any agreement, whether on a general or a sectoral basis), and secondly, Australian and New Zealand policies of protection for their manufacturing industries.

The first is less of a difficulty than appears at first sight. Japanese import restrictions apply to a wide variety of raw and processed agricultural products, with tariffs on the latter ranging from 15% to 55% ad valorem. For Australia and New Zealand the restrictions on imports of beef and veal and dairy products and (for Australia) cereals and fruits, are those of special concern. In general, imports of these products are permitted only to the extent necessary to supplement domestic production when prices exceed certain limits. Agricultural policy in Japan is directed towards the objectives of assuring food supplies, of preventing rises in food prices, and of raising rural incomes to a level more in line with urban incomes. This is the familiar inconsistent set of objectives that is found in most industrialised countries, and, as in others also, agriculture is one of the most sensitive areas of domestic policy. Although criticism of agricultural production and import policy, with its consequent effects of high and rapidly rising food prices, is not absent in Japan, it is clear that given the present political strength of the rural interests, an alternative policy of free trade in agricultural products is not in prospect. Although Japanese production of both beef and dairy products has expanded considerably in the past eight years under the influence of various assistance measures, in neither case has the growth in production been sufficient to keep up with the growth in consumer demand. Thus, not only have prices risen, but Japan has been forced to increase import quotas for these products. In the future, it is more than likely that this import gap will continue to widen. (5) In these circumstances, and given that beef is a commodity for which there is an increasing world wide demand, one might ask whether Japanese policies of agricultural support plus import quotas really mater. In the case of dairy products, the situation is more

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(5) L.V. Castle: "New Zealand Trade and Aid Policies in Pacific Trade and development" (K.Kojima ed., JERC Tokyo February 1968)

complicated, because world trade in these is very dependent on policies adopted by European countries, especially as regards the dumping of export surpluses. If Eruopean production is confined to self-sufficiency levels, and if the United Kingdom does not join the EEC, New Zealand and Australia would be the major sources from which Japanese import requirements could be met. The prospective increase in output of dairy products in both countries over the next ten years may not be sufficient to meet export demands without a rise in prices. The trade possibilities with Japan in dairy products, in spite of protectionist policies, could be such that these policies need not prove a significant barrier from the Australia/New Zealand side to a free trade arrangement which formally excluded these commodities.

Industrial protection in Australia and New Zealand is the more formidable obstacle. This is a strongly entrenched part of economic policy- and many statements from Ministers of both Governments in recent years have made it clear that they do not intend to see industries in either country going to the wall under the influence of external competition. According to Professor Arndt in an article on the PAFTA (6), "Tariff free access to the Australian market for the manufacturers of the United States, Japan and Canada at the present exchange rate would wipe out considerable sections of Australian manufacturing industry", and later, (in a somewhat different context), "nothing even like this is acceptable in Australia, now or in any foreseeable circumstances. The structural changes involved would be too formidable, even if the transition were spread out over a decade or two; and the end product insofar as its ooutlines are discernible would be an economy and society which most Australians would probably regard as a change for the worse".

These are strong views, but would find much support at policy levels in both Australia and New Zealand. One only needs to consider the great difficulties that occurred in the negotiation of the partial Free Trade Area Agreement between the two countries to realise the impossibility of contemplating within the next few years a general extension of free trade between the two countries, let alone to include Japan.

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(6) H. Arndt: "PAFTA: An Australian Assessment", A.N.U. Canberra, July, 1967.

Again, however, there are forces in operation which may modify these attitudes rather more rapidly than Professor Arndt believes. In the first place, given the present bilateral balance of trade which is heavily in their favour, both countries may find it necessary to improve opportunities for Japanese exports to them if they wish to increase sales of agricultural products and raw materials to Japan. This is a matter more of political than of economic content. Secondly, in both countries there is a growing realisation that their future industrial growth will have to proceed less on the basis of manufacture for a small local market but on the basis of specialisation and manufacture for export. This attitude was clearly at the base of the original New Zealand initiative for a free trade area with Australia in forest products. In New Zealand, too, it is now more clearly recognised that agricultural exports, even allowing for the most favourable developments in the Japanese market, are not going to be sufficient to provide even the low rate of economic growth of around 2% per caput now being planned. Manufactured exports are needed and therefore they must be competitive in world markets; this depends on an efficient internal industrial structure and specialisation in those types of products in which New Zealand can create a comparative advantage. A more open economy is seen as essential to this restructuring of New Sealand industry. The full implications of this philosophy which pervades the work of the National Development Conference now operating in New Zealand have not yet been realised, and there are still many inconsistencies in policy with that attitude. But it points, nevertheless, to a gradually emerging change of direction in thinking about the country's economic development which implies a considerable modification in protectionist policies in the next decade. Still, the emphasis is on a gradual approach to change, with nobody getting too badly hurt in the process, and thus it remains true for the next few years at least free trade in manufactures with Australia or with any other country is not in the cards.

The doubts about a free trade area arrangement between Japan, Australia and New Zealand are thus of two kinds. First, there is the major policy issue of whether, having regard in particular to the discrimination against third countries involved, with which there are even more important trade links, the best interests of the three would be served in the long run by such an arrangement rather than by working directly for a much wider association (e.g. NAFTA) in which they would be included or alternatively by seeking to promote trade among themselves by multilateral non-discriminatory means. Secondly, there are the practical political issues of whether governments of the three countries would be willing to enter an association which necessarily requires the abandonment of agricultural protection in the one case and of manufacturing protection in the other. On this second point one may note that there are forces at work which may make the problems much easier to handle in the future than they have been in the past but in the light of existing attitudes of the three governments on these crucial points, we must concede that time is certainly well beyond the perspective of five years that we presently have in mind.

An alternative and probably more fruitful approach for the immediate future, though less spectacular and less comprehensive, is to build pragmatically on what has already been accomplished in the past ten years in the establishment of institutions for trade co-operation in the Pacific. Mention may be made first of the trade agreements between Japan and Australia and New Zealand first concluded in 1958 and 1959. These agreements provided in general for the reciprocal application of most favoured nation treatment more or less in the spirit of the GATT and involved substantial reductions in Australian and New Zealand tariffs on Japanese goods. However, both Australia and New Zealand insisted on retaining rights to impose quantitative restrictions and underlined this by refusing to accept Japan's membership of the GATT in terms of Article 35 of that Agreement. As it turned out Japan adopted a very cautious attitude toward the expansion of its exports to Australia and New Zealand in the first few years of the Agreements and none of the fears held by some in New Zealand about the market being flooded with cheap Japanese goods were realised. (Given the system of import licencing which strongly protected local industry, this could hardly have happened anyway). This discriminatory aspect of the Agreements was always a source of irritation to Japan but by 1962 the climate had sufficiently changed to make it possible for both countries to accept the GATT as the main basis of trade between them and Japan. Revised Agreements were concluded in 1962 and 1963 on this basis and providing for certain further tariff concessions on each side.

The Agreements established a formal framework for regular bilateral discussions of trade and economic problems but more than this they gave a very important stimulus towards greatly extended business, professional and cultural contacts which have been instrumental in breaking down long-standing prejudices against Japanese products.

Outside government, a most useful innovation was the establishment in 1963 of the Japan-Australia Business Co-operation Committee which as Drysdale points out[7] "proved valuable not only to Japanese businessmen in their understanding of the character and potential of the Australian economy, but also to Australian businessmen in their understanding of the mutual benefits to be derived from trade with Japan and their vision of the international economy, both of which have been considerably enhanced by the dialogue with their Japanese counterparts. To those who remember the chilly reception which Australian manufacturing interests gave the first trade agreement in 1957, this development must rank among the most satisfying in the history of postwar Japanese-Australian relations". No such similar committee has yet been established between Japanese and New Zealand business interests, although this would appear to be a desirable development, judging by the Australian experience. A tentative step in this direction has been taken by the New Zealand Manufacturers' Federation in its recent decision, following a successful trade mission to Japan, to set up a committee of New Zealand businessmen having substantial business interests in Japan/New Zealand trade. Of much greater significance and potential for increasing trade in the Pacific, however, is the establishment in 1967 of the Pacific Basin Economic Cooperation Committee among business interests of Japan, Canada, the United States, Australia and New Zealand. The inaugural meeting was held in Sydney in May of this year, at which a covenant was adopted setting out the Committee's objectives. These include the promotion of trade, not only of the five countries, but also in the products of the developing countries of Asia and the Pacific. The Committee proposes to facilitate capital flows, the exchange of industrial technologies and the promotion of capital and technological cooperation with the developing countries in agriculture, mining and industry. The Committee will also engage in joint studies of problems hampering the growth of trade among members. So far the only practical step towards carrying out these objectives has been the proposal for a joint investment company with a capital of $20 million to assist in the developing countries of the area, but the

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(7) P.Drysdale; "Japan and Australia: The Prospect for Closer Economic Integration" Address to ANZ Economic Society August, 1968.

details of this and how it will operate have yet to be finally settled.

The significance of the Committee lies primarily in the fact that it provides a collective forum in which leading businessmen from the five countries can make personal contact with each other, and thus reduce the lack of knowledge among them about trade opportunities and about the special problems confronted in establishing trade links. Even more important than knowledge of products is knowledge of technology, and it is perhaps in this area that personal business contacts through the Committee may prove most valuable.

But all of these activities are bound sooner or later to come up against the constraints of official policies. Participation in the joint investment company will not be possible unless goverments give their approval for the capital outflow required. The transfer of technology and the establishment of joint ventures among the members will raise the question of foreign participation, a delicate subject in Australia and New Zealand, Canada and Japan. In the trade field, while new contacts and better information may open up profitable new opportunities, sooner or later private businessmen must come up against the constraints of tariff and other trade policies. Such policies are, to a large extent, a political response to business forces within each community; and while discussions of these problems among businessmen could result in mutually satisfactory modifications, this is rarely likely to be the case. In the final analysis, Governments must decide who is to lose and who is to gain by policy adjustments, and these are decisions which essentially are going to be taken on internal political grounds. The express exclusion of Government representatives or even observers from the P.B.E.C.C. is justifiable in the sense that their presence would be likely to shift the centre of attention away from matters with which businessmen can properly deal within the framework of policy. Nevertheless, a confrontation about policies cannot be avoided; to be fully effective, the P.B.E.C.C. really needs to be complemented by some similar organisation at Government level. The same also applies to the type of conference arranged among academics, such as this and the previous session in Tokyo. Economic analysis, business enterprise need to be linked with Government policies to form a three pronged spear, with which to attack the problems of trade and development in this area.

The proposal advanced earlier by Professor Kojima and Dr. Drysdale for the formation of an Organisation for Pacific Trade and Development offers an immediate and practical way in which the five countries might promote trade cooperation among themselves, and would provide the essential third prong of the spear which is at present lacking. Professor Kojima has suggested that it be modelled on the O.E.C.D., with three committees on trade investment and aid, and presumably also a Ministerial Council, as well as a small Secretariat. The organisational details are, however, of less importance than is making clear the purposes and functions of an OPTAD and the way in which it would add to, rather than duplicate, the work of other inter-governmental organisations, such as A.S.P.A.C., of which some or all of the five countries are now members. Further, we need also to consider whether it fulfils needs which cannot at present be met through the normal bilateral contacts between the different countries.

A first point to make is that an OPTAD should be conceived from the standpoint of the general organising principle of eventual world free trade. Whether that objective can or ever will be achieved does not matter. What is important is that OPTAD is conceived not as a first tentative step towards a tight inward-looking group in the Pacific area, but as a means by which its members can be better enabled to participate in a world trading system, even though their interests may be primarily with their Pacific trading partners. Needless to say, this comment applies less to Japan and the United States than it does to Canada, Australia and New Zealand.

From this point of view, one of the major tasks of OPTAD and one which cannot properly be carried out on a bilateral basis, is the promotion of further studies of the likely effects of a PAFTA or more limited free trade arrangements between Australia, New Zealand and Japan. Again, one need not envisage these as eventually becoming reality, but such studies could be part of a more general programme of determining the precise nature of the competitive disadvantages and weaknesses, real or imagined, which give rise to so much opposition to trade liberalisation. From this might flow proposals for a collective programme to eliminate such disadvantages and, if seen to be necessary, for a programme for the progressive elimination of industries which have no prospect of ever being economically viable. This may well involve compensating those who must be phased out, and this again is better approached on a collective basis.

This aspect of an OPTAD's work would be relevant, not only to proposals advanced for sectoral integration or free trade among some or all of the five, but also to the question of opening markets in the advanced countries for the products of the developing countries. Industrial development in the developing countries of Asia through, for example, aid programmes or the investment corporation proposed by the P.B.E.C.C. hardly makes much sense, unless it is accompanied by a willingness on the part of the advanced countries to accept the resultant products. What in effect one is suggesting is that we need internal aid programmes, so that external aid can better achieve its purpose.

The scope for joint action in structural readjustment exists not only in manufacturing but also in agriculture. In an earlier section, Japanese agricultural protection was seen as one of the major handicaps in trade relations between Japan, Australia and New Zealand. (Australian agricultural protection is also a handicap to New Zealand). Without going into details, there are clear possibilities of joint action by the three countries whereby, essentially through pooling arrangements, a different form of agricultural support and the provision of Australian and New Zealand technical assistance, relatively free trade in dairy products and meat with Japan could be established without conflicting with Japanese Government's desire to support their agricultural sector. A negotiation within OPTAD could be linked to the removal by Australia and New Zealand of the non-contractual preferences still granted to the United Kingdom and other Commonwealth countries. In terms of numbers of import items to which these apply, these are more widespread in New Zealand's case than in Australia's, but with a much smaller market their real significance in terms of trade volume is probably less. As I have suggested earlier, however, their removal could lead to important trade gains for Japan, but at the expense of the United Kingdom, Canada, New Zealand and Australia. Moreover, in order to accord with GATT they would need to be removed on a multilateral basis so that any benefits would extend beyond Japan to the United States, as well as to EEC and EFTA countries, indeed to all countries to which Australia and New Zealand accord most favoured nation treatment. Although New Zealand was prepared in the Kennedy Round to negotiate for the removal of the non-contractual margins, she was not prepared to do so unless in particular the European countries offered to liberalise their import policies for agricultural produce. This attitude may have been unrealistic, especially in assuming equality of bargaining strength and in ignoring the internal benefits that could ensue from a unilateral tariff reduction. But Governments prefer to operate in these matters on an "eye for an eye" basis. An exploration of the whole issue as an early task for OPTAD in the field of tariffs could disclose a better bargain than the one that has been sought till now. Although on this issue the emphasis is on Japan, Australia and New Zealand, the evolution of a workable agreement covering agriculture could act as a pilot project for similar approaches to the question of agricultural protection and import policies elsewhere.

In the general field of tariff policy, OPTAD could explore the possibilities of further tariff reductions among the five on a multilateral basis. It is unlikely that this would disclose any hitherto unobserved areas where tariff reductions might be made, but rapidly changing patterns of trade and principal supplier positions suggest the need for a continued surveillance. Of perhaps more relevance is the suggestion that OPTAD members should initiate a code of good conduct in the field of trade policy "under which countries would relinquish the right to raise tariffs or impose other forms of trade restriction, and would gradually reduce these barriers, particularly on the import of agricultural products and labour intensive light manufactures" [8].

A code of this kind obviously raises issues of industrial and agricultural protection which have been touched on earlier. It would need to be complemented by a variety of non-tariff measures, designed to make it possible to eliminate both tariff and non-tariff barriers to trade. Similarly, agreement not to raise tariffs or to impose other restrictions goes beyond GATT obligations and places restrictions on a country's freedom of action in industrial development that <u>simpliciter</u> it would find impossible to accept. On the other hand, and in line with the suggested collective approach to structural adjustment, such a code might best provide for a country to consult other members of an OPTAD with a view to finding if it is agreed that a particular industrial development is justified, alternative measures to assist or to establish an industry which do not restrict trade. The Canadian-American Automotive Agreement and the joint industrial developments between Australia and New Zealand in terms of Article 3(7) of the Free Trade Agreement indicate possible approaches.

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(8) K.Kojima, op.cit. p.176

The co-ordination of trade and aid policies of member countries has also been suggested as a function of an OPTAD. However, it is not very clear what co-ordination is supposed to mean in this context. If it means operational co-ordination between aid-giving countries or organisations in relation to particular projects or programmes, intervention by OPTAD is probably superfluous, given the work of the Colombo Plan, the DAG and other organisations involved with aid problems. OPTAD's functions might be of a different kind. First, as suggested earlier, in directly promoting aid projects which have as an integral part the provision of external markets when the project becomes established; secondly, in providing a quasi-multilateral intermediary between OPTAD members and developing countries recipients; and thirdly, as a means of giving "impetus and direction to the productive re-deployment of resources released through American de-escalation in Vietnam" (9). The latter, of course, depends entirely on the direction of United States policy after the Vietnam war, but OPTAD might provide a useful arms-length way in which the United States could increase its economic development assistance in the Asian and Pacific regions, or, to put it more bluntly, of ensuring a continuing United States interest in Asia and the Pacific. As Drysdale notes (10) OPTAD could provide the same kind of stimulus to Pacific economic co-operation and growth as the OECD provided for European economic co-operation and growth". Whether this would be so would depend on the extent to which members felt a sense of commitment and responsibility in the area. If that sense is for some at present weak, OPTAD would provide a focal point around which it might coalesce more strongly and securely. Membership of OPTAD would imply no more than a moral commitment to act collectively in moving towards the more progressive policies that are now required. Accordingly, since commercial policy or aid policy commitments of the kind involved in a PAFTA are not required, the United States and Canada would find no inconsistency between OPTAD memebership and their primary trade policy interests in the Atlantic. OPTAD, indeed, provides a way in which the United States might suport the development of progressive trade and aid policies in the Pacific, and provide a desirable lead "without having to declare itself in favour of trade liberalisation in Pacific Free Trade Area. (11)

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(9) Drysdale loc. cit p.15
(10) Idem p.14
(11) In K.Kojima (ed.) op. cit. p.392.

COMMENT ON PROFESSOR CASTLE'S PAPER BY PROFESSOR SOON CHOUGH

Professor Castle's clear and persuasive paper makes, I would surmise, three main points as regards alternative forms of trade co-operation of the advanced Pacific countries; firstly, neither the Pacific Free Trade Area nor the North Atlantic Free Trade Area are desirable (or feasible) for the next several years; secondly, Japan-Australia-New Zealand Free Trade Area or Customs Union (JANFTA hereafter) is not particularly desirable; thirdly, an alternative and less rigorous association of these three countries, in such form as an Organization for Pacific Trade and Development could be established to study the means of free trade among all nations.

Professor Castle's paper is concerned mainly with the second and third questions; the possibility of a Japan-Australia-New Zealand Free Trade Area and an Organization for Pacific Trade and Development. Unknowledgeable as I am about the economies of New Zealand and Australia, I would like to make a few comments on Castle's arguments about these two questions.

The paper impresses me as putting a great deal of emphasis on the importance of political, cultural, as well as economic ties between New Zealand and Australia on the one hand and United Kingdom on the other hand. The importance of political and cultural ties is plainly obvious to everyone in considering such problems as formation of a free trade area, but it can easily be overemphasized. It will be recalled that the fact that the United Kingdom is the leader of the British Commonwealth did not prevent her from applying for a membership at EEC. Indeed, if it were not for General de Gaulle, the United Kingdom would have joined EEC, and thereby would have discriminated against the exports of Australia and New Zealand. It may, of course, be true that the British interest in joining EEC is much more pronounced than the Australian and New Zealand interest in joining JANFTA, but to wait for the United Kingdom to take whatever initiative in this matter, in order for Australia and New Zealand to try to find the best possible course of action that is left over, would not always insure the economic interest of the latter two countries.

Professor Castle argues at length that the establishment of JANFTA would imperil the preferential tariff treatment accorded to the exports of New Zealand and Australia in the United Kingdom, and also it will eliminate the preferential position which Australia and New Zealand enjoy in each other's markets. He envisages that a consequence of JANFTA would be to expose Australian and New Zealand industries to severe competition from Japan, which prospect Australia and New Zealand cannot relish. It ought to be admitted that the elimination of all this preferential treatment enjoyed by Australia and New Zealand could perhaps deal a blow to the growing industries of these countries, as Professor Castle seems afraid. But one can argue that this blow would be severe and real only given the existing structures of industry and trade, and that the merit of a free trade association in the Pacific region is precisely a change in the existing trade structure. As Professor Castle argues in the early part of his paper, the attempt to foster import-substitute industries by protective tariff is not always beneficial to the long-run growth of industry. Given the small population of Australia and New Zealand, I would say that there would be a limit to the potentiality of industrial growth, if it were based only on domestic demand, and therefore these two countries would have to emphasize the growth of export industries, directed particularly to Japan and other Asian countries. The Japanese market for Australia and New Zealand is gaining importance in recent years, and there is a definite possibility that other Asian countries would also prove substantial export markets for Australia and New Zealand. This means that the opening up of Asian markets would benefit not only the agricultural sector of Australia and New Zealand, but also the non-agricultural sector.

My last comment is on the Organization for Pacific Trade and Development. Professor Castle maintains that OPTAD should not be a preliminary step towards JANFTA, but should rather be an organization purporting to free trade of the world. But one would say that, in reality, the pursuit of this purpose is, like the pursuit of virtue and happiness; it does not need an organization. OPTAD is envisaged to undertake various kinds of studies on free trade and economic aid to developing countries, and so on, but this can be done without OPTAD. Indeed, if OPTAD were formed on these bases, I would consider that delegates would find very little to talk about in their meetings. If OPTAD is to be useful, it ought to have a little more concrete objective than mere free trade.

COMMENT ON L. V. CASTLE'S PAPER BY SPERRY LEA

The author should be complimented for his perceptive grasp of U. S. trade policy prospects. My comments on his paper fall under four topics:

Firstly, I agree with the author's view in Section II that, in the eventuality of a MUFTA initiative, Japan must be included in the planning from the outset. More than this, I wonder if Japan would not be ready to fully participate sooner than generally considered, and probably sooner than EEC, because of the size and structure of Japanese industrial units.

Secondly, in the discussion of JANFTA, a major characteristic was clearly — and, in my view, correctly — identified. This is that it would take the form of a Free Trade Area rather than a Customs Union. But several essential characteristics were omitted. The most important such question is membership. Is it Professor Castle's idea that JANFTA would be open ended to other Pacific or Asian countries, of which Taiwan and Korea would appear to be leading candidates? (Perhaps Conference participants from these countries would like to comment on the attractiveness of JANFTA to them.)

A second basic characteristic of JANFTA deserving more clarification is commodity coverage.

Thirdly, as the "most formidable obstacle" to JANFTA, Professor Castle gives industrial protection in Australia and New Zealand. He writes, "This is a strongly entrenched part of economic policy, and many statements from Ministers of both Governments in recent years have made it clear that they do not intend to see industries in either country going to the wall under the influence of external competition." A quotation from Professor Arndt's assessment is then given to support this view. A few pages later, Professor Castle — referring to industrial protection in Australia and New Zealand, and looking to a future beyond five years — states "there are forces at work which may make the problems much easier to handle in the future than they have been in the past." But the paper does not describe what these eventual forces are. We would like to know something about them because they would be a most important factor in enabling Australia and New Zealand to join not merely JANFTA, but also some form of broader free trade arrangement of the MUFTA variety.

Finally, I have two questions about what Professor Castle considers the most fruitful approach to trade cooperation among developed Pacific countries, the OPTAD. (1) There is no mention of participation, sooner or later, of other Pacific nations than the five developed ones. (Japan, Australia, New Zealand, Canada, and the United States). Again, where would Korea and Taiwan, to mention two, stand? I wonder if the United States would wish to participate in an organization that was restricted to the developed countries only. (2) Since the OPTAD has been described as a kind of OECD in the Pacific, how would Professor Castle regard the widening of OECD membership to include Australia and New Zealand?

Chapter 7

JAPAN, AUSTRALIA, NEW ZEALAND: THE PROSPECT FOR WESTERN PACIFIC ECONOMIC INTEGRATION

Peter D. Drysdale

During the past year, the politico-economic environment in which Australia must ultimately shape her international economic policies has undergone dramatic change. First, the whole sequence of international monetary distrubances, involving devaluation of sterling, speculation in gold against the dollar, and the need for the United States to impose restraints on private overseas investment, produced two significant shifts in American attitudes towards the conduct of international economic policy by the United States' Administration. One was that the upsurge of protectionism in the United States, which followed the completion of the Kennedy Round of tariff negotiations in 1967, was increasingly re-inforced by appeal to concern about the balance of payments (11). The other was that the mood which had already induced substantial reductions in overseas defence and development assistance expeditures gathered strength so that, this financial year, aid was cut by Congress to a record-low figure of $US 1750 millions. Second, on top of all these events, there was the decision of President Johnson to stand down, and the sudden realisation of eventual American military withdrawal from the Asian mainland. That development has given the question of alternative economic and political strategies to ensure stability and progress in the Asian-Pacific region a new urgency.

What direction United States' policies take is of interest to every nation involved through trade and commerce in the world economy, so large is the American economy in relation to the rest of the world and so great is her influence on its economic behaviour. But the direction that United States' policies take is of special concern to Australia, and to Japan, Australia's largest trading partner.

In postwar years, there has been a significant restructuring of Australia's economic relations with the rest of the world, largely through the remarkable shift in the geographic distribution of her commodity trade away from Britain and Europe towards the Pacific and Asia. Over 40 per cent of Australia's trade is now done with advanced Pacific countries - Japan, the United States, Canada, and

New Zealand. About 60 per cent of Australia's export trade and 50 per cent of her import trade is with the Asian-Pacific region. Between 1950 and 1968, Japan's share in Australian exports alone rose from 4 per cent to 21 per cent, the United States' share rose from 8 to 13 per cent, New Zealand's share rose from 3 to 5 per cent, whilst the United Kingdom's share fell from 39 per cent to 14 per cent. Throughout the same period, the United States' share in Australian imports rose from 10 per cent to 26 per cent, Japan's share rose from 1 to 10 per cent, New Zealand's share rose from 1 to 2 per cent, whilst the United Kingdom's share fell from 52 per cent to 22 per cent. Furthermore, the growth of trade between the United States and Australia was closely associated with the growth of large scale American investment in the development of Australian industrial capacity. Add to these developments the fact the Japanese economy remained even more closely involved through trade and commerce with the United States, which takes around 30 per cent of her exports and provides a similar proportion of her import supplies, and the fact that much of the impetus to growth in the rest of Asia still derives from United States' trade and economic and military assistance, and there is evidence enough of Australia's huge stake in the direction of American trade, aid, and investment policies as they affect the Pacific and Asian region.

How should Australia's commercial diplomacy be cast in the light of both these longer-term and more recent developments in regional trade and international economic policies? What initiatives can Australia take to ensure that economic progress and stability in the region which most directly impinges upon her own prosperity is promoted? What restraint can Australia hope to exercise on the United States if she becomes more and more inward-looking and protectionist-minded? With these questions in mind, would closer economic integration among the three advanced western Pacific nations be a step in the right direction?

The Structure of Trade in the Western Pacific Region

Elsewhere, the character of trade, and the prospect for integration, among the five advanced Pacific nations have been analysed in some detail (13). Here the focus of attention is Australia's interest in closer integration among the three advanced western Pacific nations - Japan, Australia, and New Zealand. In this context, the position of other Asian and South East Asian trading partners requires special consideration.

Shifts in the structure of Australian trade with the western

Pacific resulted from three broad sets of factors: the relatively rapid growth of Japan's share in world trade; the underlying complementarity between the structure of Japanese and Australian trade and modest growth in the complementarity of Australia's export trade with New Zealand; and factors affecting the geographical, political, and historical closeness of Australia to both economies.

Two countries trade more or less intensively with each other than they do with the rest of the world because of the particular commodity composition of their trade in relation to world trade - this may be called the degree of complementarity in bilateral trade- and because of their geographical proximity and special institutional and historical ties - this may be called the degree of special country bias in bilateral trade. The degree of complementarity and the degree of special country bias jointly determine the intensity of trade between two trading partners.

The concept of 'complementarity' is often used loosely to describe the extent to which countries have dissimilar resource endowments and structures of production and are therefore likely to trade intensively with each other. Here the concept is defined in a very precise way. It is defined in a relative sense and measures the extent to which one country's export pattern matches another country's import pattern more closely than it matches the pattern of world imports. An index of the degree of complementarity in bilateral trade (C_{ja}) can be derived to measure exactly the extent to which country J's exports to country A are relatively large because the commodity composition of J's exports matches that of A's imports more closely than it matches the commodity composition of world trade. It follows that for each pair of countries, in a many-country, many-commodity world, there are two measures of the degree of complementarity in bilateral trade - one is derived from the flow of J's exports to A, and the other from the flow of A's exports to J.

The concept of special country bias in bilaterial trade (B_{ja}) is defined to measure the extent to which J's exports have more or less favourable access to A's import markets than might be expected from both countries' shares of world trade in each commodity.

Table 1

Complementary, Special Country Bias, and Intensity in Japan-Australia-New Zealand Trade 1966[a]

Exports from \ Exports to		Australia	Japan	New Zealand
Australia	c		186	58
	b	-	216	2104
	i		401	1220
Japan	c	148		145
	b	135	-	85
	i	200		123
New Zealand	c	20	125	
	b	1400	119	-
	i	280	149	

a. Row i measures the intensity of trade. An index of 100 indicates that one country exports (imports) exactly that proportion of its total exports to (imports from) another country as that country's share in world trade. Row i equals row c, complementarity in trade, multiplied by row b, special country bias in trade, divided by 100.

Source: Calculations based on data and procedures described in (7).

Complementarity and special country bias together determine intensity of trade. The intensity of trade (I_{ja}) measures the extent to which country A's share in J's total exports is large or small in relation to A's share in world trade.

The results of a detailed study of complementarity, special country bias, and intensity in western Pacific trade flows are presented in Table 1. The methods by which these indexes are calculated, and a brief description of the data upon which the calculations are based, were described in an earlier paper (7). Row c records the degree of complementarity, row b records the degree of special country bias, and row i records the intensity of trade index for each bilateral trade flow. Take Australia's export trade with Japan. The results of this study reveal that, simply because of the character of Australian export specialisation and Japanese import specialisation in world trade for 1966, Japan's share in Australia's export trade should have been almost twice as large as her share in world imports; further, that Japan's share in Australian exports was slightly more than twice as large as might be expected from both countries' shares in world trade of each commodity; and that, therefore, Japan's share in Australia's export trade was four times as large as might have been expected from her share in world imports. That is, the degree of complementarity in Australia's export trade with Japan was 186, the degree of special country bias was 216, and the intensity of trade was 401.

The general picture which emerges from Table 1 is that trade among advanced western Pacific countries is highly intensive. There is a high degree of complementarity in trade between Japan and Australia, and Japan and New Zealand. The degree of complementarity in trade between New Zealand and Australia is naturally quite low. The degree of special country bias is extremely high in trade between New Zealand and Australia, and Japan and Australia. It is also reasonably high in New Zealand's export trade with Japan. But it is quite low in New Zealand's import trade with Japan. The net result is that even where the degree of complementarity in trade is relatively low, intensity in trade remains high.

Among the three countries, Australia enjoys the highest intensity of trade with other advanced countries in the western Pacific region as a whole. The intensity of Australia's export trade with the other advanced western Pacific countries (472) is extremely high. The intensity of her import trade (202) is also very high. New Zealand's trade with the region, and Japan's too, is more heavily concentrated on Australia alone.

Australia's export trade with Japan reveals the highest degree of complementarity, whilst complementarity in her export trade with New Zealand is still relatively low. A high degree of complementarity has long been a feature of Australia's export trade with Japan. During the postwar period, it was of major importance in causing Japan's overall trade growth to stimulate proportionately larger import purchases from Australia. In the earlier phases of postwar Japanese growth, increased import demand was heavily concentrated on textile raw materials and provided new outlets for exports of Australian wool. In later phases, accelerated heavy industrialisation and new patterns of consumer demand associated with higher income levels strengthened Japanese import demand for fuels and minerals, such as coal, iron ore, copper, bauxite, and alumina, and footstuffs such as wheat, meat, and dairy products. Complementarity in Australia's export trade with New Zealand, whilst low, is perhaps larger than might have been expected from a superficial consideration of the broad structures of the two economies. The index of complementarity for this trade flow indicates Australia's stronger export specialisation in manufactures, as well as New Zealand's strong import specialisation in wheat, sugar, and other foodstuffs in which Australia's export specialisation has always been strong.

Special country bias in Australia's export trade with New Zealand is extremely high, and it is also very large in export trade with Japan. The extremely high degree of special country bias in export trade with New Zealand results from geographical nearness, preferred tariff arrangements under the Commonwealth Preference Scheme and the New Zealand-Australia Free Trade Agreement, and market homogeneity and familiarity. Australia's manufactured exports are heavily concentrated in the New Zealand market. Much of the special country bias in Australia's export trade with Japan is accounted for by the special nature of Australia's trade with Japan in raw wool, and the influence of transport costs, these latter considerations being a major factor in encouraging the development of Australia's huge deposits of high quality and accessible coal, iron ore, and bauxite for export to Japanese buyers (5).

The degree of complementarity in Australia's import trade with Japan is very high. On the other hand, it is extremely low for import trade with New Zealand. After a period of steady decline throughout the early sixties, complementarity in Australia's import trade with Japan increased sharply from 118 to 148 between 1965 and 1966. The former trend became evident during an intermediate stage in the postwar transformation of Japanese export specialisation away from strong specialisation in light industrial exports towards stronger specialisation in heavy industrial exports. The predicted reversal has come rather dramatically (13, 5). In part, the higher degree of complementarity derived from stronger Japanese export specialisation in commodities across the whole range of machinery and equipment, but there were also special factors influencing Australia's import specialisation in 1966. Significantly, Australia imported three warships. The size of these imports distorted the normal strength of import specialisation for ships and boats in which commodity group, of course, Japan's export specialisation is extremely strong. A large part of the sharp rise in complementarity in Australia's import trade with Japan during 1966 is attributable to this special cause. Low complementarity in trade with New Zealand reflects the competitive nature of the two economies.

Special country bias in import trade with Japan is quite high but somewhat lower in 1966 than it was for the previous year. The fall is almost entirely attributable to the effect of the purchases of warships from the United States on overall special country bias. More significantly, the breakdown of special institutional and policy biases against trade between the two countries has permitted a remarkable expansion in bilateral trade in recent years. The trend is for the index of special country bias in Australia's import trade with Japan to rise. As might be expected, there is extremely high special country bias in import trade with New Zealand, a product of the same institutional factors which are act to stimulate bilateral trade in the reverse direction.

Trade links between Japan and New Zealand are less well developed. Although complementarity is high for both trade flows, special country biases are not very high. The re-orientation of New Zealand's economic relations away from traditional markets in the United Kingdom and Europe towards nearer growth markets in the Pacific and Asia has proceeded at a much slower pace than for Australia. Partly this is explained by institutional factors and the greater stress placed on British ties in New Zealand; partly it is a consequence of the fact that the structure of New Zealand's export specialisation, notably in coarse carpet wools and dairy products, was less obviously tuned to the growth of Asian-Pacific trade (15).

Alongside developments in Australia's trade with the Pacific area has been the growing importance of Australia's trade with Asia. Between 1950 and 1968, Australian exports destined for Asia rose from 11 to 18 per cent, partly because of large wheat sales to China, and partly because of increased exports of manufactured goods to the region. Exports to developing countries in Asia and the Pacific, excluding mainland China, comprised 16 per cent of total Australian exports in 1968. As observed in an earlier paper, the propinquity of Asian markets and certain similarities in the structure of Australian and Asian demand for industrial goods have facilitated this new trade. Trade in manufactures with Asia and New Zealand assumed special importance in policies designed to strengthen Australia's industrial base through the expansion of export markets (7).

Imports from developing countries in Asia and the Pacific, excluding mainland China, fell from 13 per cent of total Australian imports in 1950 to only 8 per cent of total Australian imports in 1968. The falling share of Asian imports largely resulted from reduced demand for raw materials. But the performance of Asian exporters in Australian markets was variable. Some Asian countries are increasingly competitive suppliers of textiles and light manufactures and their share in Australian markets for these products has tended to grow at the expense of the United Kingdom and Japan.

A detailed study of complementarity, special country bias, and intensity in trade flows between advanced western Pacific countries and selected developing countries in Asia and the Pacific is presented in Table 2a and Table 2b.

Both Australia's and Japan's export trade with these countries appears highly intensive. The intensity of New Zealand's trade with the region is generally very low.

Complementarity in Australia's export trade with Asian Pacific countries, with the exception of Indonesia, is probably higher than might have been anticipated. Complementarity in Japan's trade is mostly very high as might have been expected. Complementarity in New Zealand's export trade is lower than in Australia's but not low enough to explain the exceptionally low intensities in her trade with the region.

Special country bias in Australian and Japanese export trade with the region is commonly very high. An interesting feature is the inverse variation in the high special country biases of these two countries, closely correlated as it is with the political and institutional closeness of countries with British connections and the facts of geography. New Zealand has exceptionally low special country bias in her export trade with the region. She has been slower to take advantage of the trading opportunities that exist in Asian-Pacific markets, even for a country so heavily specialised in the export of temperate zone primary products.

Intensities in Australian import trade with the region reveal considerable variation. The intensity of import trade with near-

Table 2a

Complementarity, Special Country Bias, and Intensity in Japan-Australia-New Zealand Trade with Asian Countries, 1966

Exports from / Exports to		Hong Kong	Indonesia	Malaysia	New Guinea	Philip-pines	Singapore	South Korea	Taiwan	Thailand
	c	90	43	80	84	84	62	138	99	54
Australia	b	267	97	424	5088	215	287	47	226	115
	i	240	42	339	4274	181	178	65	224	62
	c	139	222	97	127	140	94	167	140	119
Japan	b	320	211	171	102	441	247	599	621	461
	i	444	469	166	130	617	232	1000	870	548
	c	75	15	73	78	67	56	38	78	43
New Zealand	b	20	45	136	0	203	60	45	27	13
	i	15	7	99	0	136	34	17	21	6

a. Row i measures the intensity of trade. An index of 100 indicates that one country exports (imports) exactly that proportion of its total exports to (imports from) another country as that country's share in world trade. Row i equals row c, complementarity in trade, multiplied by row b, special country bias in trade, divided by 100.

Source: Calculations are based on data and procedures described in 7 .

Table 2b

Complementarity, Special Country Bias, and Intensity in Japan-Australia-New Zealand Trade with Asian Countries, 1966

Exports to \ Exports from		Hong Kong	Indonesia	Malaysia	New Guinea	Philip-pines	Singapore	South Korea	Taiwan	Thailand
	c	122	79	66	50	26	97	83	74	42
Australia	b	123	813	133	5498	96	144	42	66	29
	i	150	642	88	2749	25	140	35	49	12
	c	27	166	234	171	354	99	101	83	262
Japan	b	236	354	169	67	204	83	594	520	151
	i	64	587	396	115	723	82	600	432	395
	c	106	64	58	30	32	95	78	80	43
New Zealand	b	277	141	131	306	20	165	0	77	33
	i	294	90	76	92	6	157	0	62	14

a. Row i measures the intensity of trade. An index of 100 indicates that one country exports (imports) exactly that proportion of its total exports to (imports from) another country as that country's share in world trade. Row i equals row c, complementarity in trade, multiplied by row b, special country bias in trade, divided by 100.

Source: Calculations are based on data and procedures described in 7 .

by suppliers of raw materials, such as Indonesia and New Guinea, is estremely high because of special country bias in trade. At the same time, the intensity of trade with exporters of light manufactures and processed raw materials, such as Hong Kong and Singapore, is quite high because of complementarity in trade. Almost the reverse generalisations apply to Japan. Intensities in Japan's import trade with the region are mostly very high both because of high degrees of complementarity in trade with raw material exporters and high special country bias in trade with exporters of manufactures. With the exception of Hong Kong and Singapore, intensities in New Zealand's import trade with the region are very low.

This analysis of the structure of trade in the western Pacific region leads to two broad conclusions. First, the nature of intensity, complementarity, and special country bias in trade flows among advanced western Pacific nations suggests that policies designed to promote closer integration, especially between Japan on the one hand and Australia and New Zealand on the other, would be beneficial. However, regional trade constitutes a very small proportion of each of these country's trade, being largest for Australia which, in 1968, sent 26 per cent of her total exports to, and obtained 12 per cent of her total imports from, the other two advanced western Pacific partners. Thus, there is a strong presumption that complete intra-areal free trade is likely to be accompanied by more trade diversion than trade creation. It is nonetheless worthwhile investigating the trade creating effects of such a limited free trade area more closely, and this will be attempted in the next section.

Second, linked by high complementarity in exports and imports with Japan, and high special country bias with both Australia and Japan, the developing countries in the Asian-Pacific region are proportionately much more important to the trade of these two countries than they are to the world at large. Indeed, Japan and Australia have weighty political, as well as economic, interests in the region's prosperity. Thus, there is a strong case for coupling any policy initiatives by advanced western Pacific nations with the extension or adoption of trade policies specially designed to accommodate the needs of developing countries in the Asian-Pacific region.

The Impact Effect of JANFTA on Australia

The effects of a move towards free trade in the western Pacific area upon the Australian economy are impossible to calculate precisely (15). But the likely nature and magnitude of the important direct gains, as well as the important costs of adjustment that would follow the establishment of a free trade area among Japan, Australia, and New Zealand, coupled with the non-reciprocated removal of tariffs by these countries against imports from developing countries in Eastern and Southern Asia, are worth trying to specify roughly. Moreover, it is useful to focus on the impact of the most radical proposals for integration and trade preferences, not because an immediate move towards the establishment of a Japan-Australia-New Zealand Free Trade Area seems on the face of it either desirable or feasible, but because it represents a convenient means of analysing the effects of these and less radical alternatives on Australian trade and industry. Later, some of the important, but even less certain, dynamic effects can be considered.

A detailed study, using national tariff data and three digit SITC commodity trade data for 1966, was made to estimate Australian import and export expansion in consequence of the trade creating effects of tariff elimination amongst advanced western Pacific countries and the elimination of Australian tariffs on imports from developing countries in Asia.

The impact effect of tariff reductions on trade depends upon the height of the original tariff, changes in tariff rates, and the relevant price elasticities of demand and supply. Assuming infinite elasticities of export supply, the change in imports (and exports) can be measured using the formula:

$$\Delta M = \alpha \frac{t}{100+t} \eta M$$

where ΔM is the change in imports due to tariff reduction, α is the rate of tariff reduction, t is the original tariff level, η is the price elasticity of import demand, and M is the original value of imports.

The price elasticities of import demand used in this study are those adopted in an earlier study. They incorporate estimates of price elasticities for agricultural commodities of importance in Australian exports superior to those used in earlier studies (7).

Estimates of the effect of western Pacific area tariff elimination on Australian trade are presented in Table 3. As reported elsewhere, the height and structure of Australian tariffs and relatively high price elasticities of demand for Australian imports suggest that there would be a substantial percentage increase in imports on given trade volumes. On the other hand, lower tariffs and lower price elasticities of import demand for Australia's principal exports to Japan, in particular, restrains export expansion that would follow western Pacific area tariff elimination. However, initial Australian imports from the region are quite small whereas exports to the region are relatively large. Estimated trade expansion is therefore quite modest. Moreover, deterioration in the balance of payments would be insignificant. Trade expansion with western Pacific countries in consequence of tariff elimination may, for example, be compared with the expansion of trade that would follow the elimination of tariffs among the five advanced Pacific basin countries, together with the removal of tariffs on imports from developing countries in Asia. In the former event, Australian imports would increase 9.1 per cent and exports 3.4 per cent. In the latter event, Australian imports would increase 28.8 per cent and exports 7.9 per cent on 1966 trade figures.

These estimates do, however, suggest a larger expansion of imports from developing countries (about $US 74 millions) than Kojima's most recent estimates. The differences in estimation result from the use of slightly different price elasticities, the use of more detailed Australian tariff data, and the use of weighted and selected tariff rates rather than average nominal rates.

Table 3

The Effect of Western Pacific Area Tariff Reductions on Australian Trade, 1966

	Merchandise Imports ($USm)	Merchandise Exports ($USm)
Trade with World	3197	3074
Trade with Japan, New Zealand, and Other Asia	552	719
Increase in Trade with Japan, New Zealand, and Other Asia	291	104
Percentage Increase in Trade with World	9.1%	3.4%

Source: Calculations are based on methods and data described in the text.

A rough attempt was also made to guage the effect of import expansion on production and employment. The largest declines in production would be located in textiles (9-10 per cent), miscellaneous manufactures (9-10 per cent), metals and machinery (2-3 per cent), and chemicals (1-2 per cent). Motor vehicle production accounts for 33 per cent of the decline in metals and machinery, electronics and electrical apparatus account for 18 per cent, and miscellaneous metal manufactures account for 12 per cent. The fall in chemical production is probably underestimated since the prevalence of special protective measures makes it difficult to measure the height of the tariff satisfactorily. Thus, if estimated import expansion were the only effect of tariff elimination, the total decline in manufacturing production would be of the order of 2 or 3 per cent. The structure and size of these changes imply the necessity to redeploy about 40,000 to 50,000 industrial workers or about 3 to 4 per cent of the manufacturing workforce in 1966. These adjustments may be compared with the effect of including North America in the free trade arrangement. In that case, there would be an 8 or 9 per cent fall in manufacturing production, necessitating the redeployment of 9 or 10 per cent of the manufacturing workforce.

The effect of import expansion will not be the only effect on the manufacturing sector. Export expansion should also be taken into account. Export expansion would lead to a compensating expansion in production and employment, most significantly in the metal and machinery industries. Increased exports, for example, would compensate for half the increase in imports of motor vehicles. And no allowance has been made in this study for the effect of non-tariff restrictions on imports of motor vehicles into Japan and New Zealand. Exports of pig iron; primary iron and steel; iron and steel bars, rods, angles, shapes, and sections; crude copper manufactures; crude aluminium manufactures; lead and zinc; wire products; non-electric power generating machinery; agricultural machinery and equipment; and some types of domestic electrical equipment would all expand singnificantly more than imports. The bulk of machinery and equipment produced in Australia would remain competitive. Of course, the largest part of export expansion would derive from primary industries, but the 30-40 per cent contribution from manufactures in very large.

These estimates are simply designed to illustrate the general magnitude of the adjustment problems in consequence of the static trade creating effects of the establishment of a comprehensive western Pacific free trade area. Other effects would also be important. In the first place, trade diversion would probably be substantial. One study hinted that Australian imports valued at about $US 170 millions might be diverted from the United Kingdom alone to new sources of supply in the western Pacific. About half of this shift would comprise pure trade diversion (13). In the second place, the dynamic effects are likely to swamp the static effects of economic integration for relatively small economies such as Australia and New Zealand. They require more detailed study, not only in the context of a comprehensive free trade area but also under alternative arrangements. For Australia, realisation of dynamic gains is at once the most important and least certain objective of Pacific economic integration. Some of the uncertainties may be avoided and the gains preserved if a less comprehensive approach to integration were adopted.

Dynamic Effects and the Scope for Sectoral Integration

The calculations in the previous section serve two purposes. First, as already noted, they specify the impact of adjustment costs. Second, they point to some of the possibilities for initiating larger dynamic changes through economic integration. They provide a useful background for analysing the important dynamic effects whether integration is approached on a broad front or whether a sectoral approach is adopted. However, measurement of the impact of western Pacific free trade, based on existing supply and demand structures, presents an inadequate description of the total effect of integration. As each economy adjusted over time to new relative prices, changes in the basic structure of each national economy would occur. For example, integration would be associated with capital flows, both within the region and from beyond the region, as production for regional markets re-located to take advantage of economies of scale or cheaper natural resources, as businessmen and officials become more aware of market and investment opportunities, and as firms adjusted to a new dimension in competition.

The dynamic effects are complex and difficult to predict accurately. Their general nature was discussed in a paper delivered in Tokyo last year and it is not necessary to cover that ground again (7). Rather, the discussion here can be confined to a preliminary assessment of the prospects for the integration of a few key industrial sectors within the framework of a complete western Pacific free trade area, a sectoral free trade agreement, or without any tariff re-arrangements at all. The three sectors - motor vehicles, iron and steel and non ferrous metals - discussed below comprise at present about 25 per cent of Australian manufacturing output.

Scope for benefits from sectoral integration exists because national policies or national business institutions can frustrate the optimal regional location of industry from the viewpoints of economies of scale, minimisation of transport costs, and intensive use of high quality resources specific to one part of the region. Tariffs and import restrictions are the most important national policies which have this effect. Autarkic business integration and purchase agreements are the most important business institutions which work in exactly the same direction. The latter are important in every country, but they are, perhaps, of special importance in Japan and advanced western Pacific countries.

The three types of benefit which derive from sectoral integration are clear in principle. First, in industries with access to significant economies of scale, high protective barriers made secure by government support, can lead to the duplication of plants of sub-optimal scale. The automobile industry in the advanced western Pacific countries typifies this situation. Second, protection of basic treatment processes that require large inputs of low value to weight raw materials prevents treatment closer to resource deposits, and high transport costs are needlessly added to the cost of the product. Pig iron production is a good example of an industry which thrives on location close to sources of raw materials. Finally, protective barriers can lead to the establishment of industries outside countries with important advantages in the quality and costs of inputs. The aluminium smelting industry, which requires large volumes of electricity, is one such case.

Wherever economies of scale are important, and wherever two or more countries are producing sub-optimal outputs at high costs, there is room for gain through more efficient international specialisation. Most commonly this kind of inefficiency results from the imposition of protective tariffs, but it can arise quite independently of the existence of trade barriers (12).

Economies of scale are important in motor vehicle production. It is usual for costs to fall sharply up to an output of about 50,000 units per annum, with a further 15 per cent saving when output is doubled to 100,000 units, a 10 per cent saving with the doubling of output to 200,000 units, and a further 5 per cent saving at 400,000 units (14). There are some economies, especially in pressing, to be realised at outputs above a million units, but an output of 400,000 should ensure the international competitiveness of a fully integrated plant. In fact, much lower outputs can be sustained competitively because motor vehicles are highly differentiable and because of the significance of transport costs.

A fully integrated Australian motor car industry has been operating since the early fifties, first with the assistance of import restrictions, later protected by tariffs. The tariff on fully built-up vehicles was recently raised from 35 per cent to 45 per cent m.f.n. in response to the growing competitiveness of some Japanese imports. High tariffs had earlier encouraged the entry of a number of low-volume competitors to the two well-established manufacturers. Until the early sixties total production of passenger cars in Australia was absolutely larger than in Japan, and Australian costs were generally lower. Japanese motor car production has grown remarkably since 1960 but large-scale production is concentrated in a few among many producers and the industry is still protected by a 40 per cent tariff, to be reduced under the Kennedy Round, and, more significantly, quantitative restrictions on imports of components and parts.

At the end of 1967, Japanese passenger car production, at about 1,400,000 vehicles, was over four times the size of Australian output. However, Japanese production was heavily concentrated in the small car range, 82 per cent of output being cars of less than 1500 c.c. cylinder capacity, whereas Australian production was concentrated in the medium-large range, with 75 per cent of output being cars of 1400 c.c. and over, and 63 per cent of output in the range above 2,200 c.c. Indeed, the absolute size of Australian output was still larger than that of the Japanese industry for cars of greater than 1500 c.c. capacity. In other words, the Japanese industry could support several producers of small cars operating at optimal scale, and one producer of small-medium cars operating reasonably efficiently. Australian production could support one completely competitive fully integrated producer of medium sized cars operating close to optimal scale or two or three reasonably competitive producers operating at lower volumes.

There appears considerable scope for more effective specialisation in motor car production within the western Pacific region, with Japan specialising in the production and export of small and small-medium sized passenger cars, and Australia specialising in the production and export of medium-sized cars. Costs would fall in both industries and the competitive position of both industries would be strengthened in third country markets. Producers and consumers in both countries would share the benefits of lower cost production. As the structure of motor car demand changes with increasing per capita incomes in both countries, paradoxically the scope for more competitive medium-sized car production will grow in Australia. Meanwhile, it appears quite irrational to subsidise the whole range of passenger car production in both countries where the viability of the important section of the industry in each country is well established.

What kind of arrangement between the Japanese and Australian motor vehicle industries might be beneficial and acceptable? At various times, the reduction of m.f.n. tariffs and removal of other restrictions have been advocated in both Japan and Australia. However, it is very difficult to stage m.f.n. tariff reductions without giving rise to considerable and unpredictable dislocation in production and employment, and without encouraging the encroachment of third country competitors. The only manageable arrangement would seem, therefore, to involve preferred access for Australian medium-large cars in Japanese markets and preferred access for Japanese small cars in Australian markets. There is the North American precedent of a GATT waiver for such an arrangement. But to effect yet another policy reversal on the motor vehicle industry of the kind that this would involve in Australia is wildly improbable unless the Japanese industry were prepared to make substantial concessions. There are some circumstances under which this might eventuate. The Australian industry is American dominated. It would be quite rational for American firms to service penetration into the Japanese market from their Australian capacity, partly because of lower transport costs, partly because of the suitability of their Australian models for the Japanese market, and partly because of the high marginal gains from larger Australian production (6). To the Japanese industry, and Japanese government, this might appear infinitely preferable to fully integrated American production and investment within Japan itself.

Raw materials are an important element in costs in the basic metal industries. Raw materials account for around 60 per cent of the value of Japanese produced pig iron. Of these costs, between one third and one half, or 20 to 30 per cent of the total cost of pig iron, represents the cost of freight. The cheapest and most convenient raw materials used by the Japanese industry are imported from Australia. It would therefore appear that, provided auxiliary resources were available at comparable prices, large benefits would derive from re-locating in Australia pig iron capacity to serve the Japanese steel industry.

In fact, comparison of Japanese and Australian pig iron price suggests that auxiliary resources are available as cheaply in Australia as in Japan. In 1967, the published price of Australian pig iron at $US 55.05 per ton was 27 per cent lower than that for Japanese pig iron at $US 75.20 per ton. The Australian export price at about $US 42 per ton, is 40 per cent below the Japanese domestic price. The present cost of freight for large lots from Australia to Japan is $US 8.40 per ton or around 20 per cent of the Australian export price. Freight costs on pig iron would probably be lowered if the volume of trade in pig iron grew.

Since the 10-12 per cent Japanese tariff on pig iron does not raise the price of pig iron imported from Australia above the domestic price level, business institutions can be presumed to prevent effective competition in the Japanese market. The degree of autarkic business integration in the Japanese iron and steel industry is large. Moreover, the insitutional structure of the Australian industry has not, in the past, been conducive to pushing large scale export production, so that the opportunities for more efficient regional specialisation have not been realised.

Although published data suggest that the Japanese iron and steel industry might have been slightly more efficient in the production of basic steel products than the Australian industry, there is probably considerable scope for rationalisation in the production and trade of certain steel products too. This would tend to favour crude steel exports, with a high material input, from Australia, and specialised steel exports from Japan.

What kind of arrangements for the Japanese and Australian iron and steel industries might be beneficial? No discriminatory arrangements would be necessary since the highly efficient Australian basic iron and steel and Japanese steel industries would not be threatened by third country producers. In the longer run, m.f.n. tariff concessions by both countries would give rise to increased regional trade and improve the competitive position of western Pacific producers in other markets, not only in steel products but also in products for which steel is an important input. More significant than tariff concessions would be the initiation of moves to break down protective business institutions. In particular, investment in iron and steel capacity could be planned and encouraged from a regional rather than national point of view. This would be facilitated by joint business ventures and tie-ups, the freer flow of investment within the industry, and direct government intervention.

Economies of scale are important at all stages of aluminium production. The region's bauxite mining and alumina refining industries, both increasingly important suppliers of world markets, are already operating at efficient levels of output. However, in aluminium smelting, where economies of scale are obtained up to production of about 100,000 tons per annum, and beyond if lumpy investments in electric power generation are required, there are plants of sub-optimal capacity operating. Transport costs for bauxite and alumina are an important element in the costs of the Japanese industry, and costs could be reduced by locating alumina production and smelting close to high quality Australian bauxite deposits. However, this discussion will be confined to the third type of potential gain through regional integration: the more intensive use of high quality resources specific to one location within the region.

In this case, the potential for generating electricity cheaply is the specific resource. Electric power is a major input in aluminium production - estimates place requirements at over 17,000 kolowatt hours per ton of metal (1). Thus, the price of electricity is extremely important in determining the cost of smelting. New Zealand, New Guinea, and perhaps other parts of South East Asia, have potential for generating hydro-electricity more cheaply than electricity can be produced in Australia, and much more cheaply than it can be produced in Japan. Thus, the power costs of aluminium produced at the smelter planned for Bluff in New Zealand will possibly be in the vicinity of $US 38 per ton - compared with typical costs two and a half times as high in Australia and more than five times as high in Japan. The differential is significant, given a world aluminium price of about $US 560 per ton. Production in Japan is sustained only behind an effective rate of protection over 40 per cent, and through high cost aluminium production being carried by efficient fabricating within integrated firms. Australian production is more efficient than Japanese, but even here there may be some scope for more effective specialisation.

A prototype of the kind of development that is possible within the western Pacific region is provided by the Comalco-Showa Denko K.K. - Sumitomo Chemicals venture in New Zealand. Based on the Weipa, North Queensland, bauxite of Comalco, which is refined in Queensland Alumina's Gladstone plant, a smelting industry is to be established at Bluff in New Zealand. A large investment in hydro-electric capacity will be undertaken by the New Zealand government at Lake Manapouri, and power will be supplied to the smelter at a cost around 0.2 cents per kilowatt-hour. The availability of government capital and demand for electricity made Manapouri more attractive than sites in New Guinea. Part of the aluminium produced will be sold by Comalco in New Zealand and overseas and part will be taken by the Japanese parties for fabrication in Japan.

What measures can be taken to stimulate more of this highly desirable rationalisation of the region's aluminium industry? Our conclusions are similar to those for the steel industry: the efficiency of Australian bauxite mining and refining, New Zealand's electricity generation, and Japan's fabricating industry would make m.f.n. tariff reductions by all parties on aluminium and aluminium products a sufficient condition for increased intra-regional trade and output. Again, the breakdown of autarkic business integration would be an important objective. The tripartite venture in New Zealand, and Furukawa's agreement to purchase increased volumes of aluminium ingot from Alcoa's Australian capacity, give ground for optimism in this regard.

The vision of greater economic progress through closer integration of some sectors of the advanced western Pacific economies that is the theme of this paper, has been expressed clearly by Sir Maurice Mawby, Chairman of Conzinc Riotinto of Australia, a major shareholder in Comalco Industries:

"The formation of the Bluff smelter project (based on Manapouri power) reflected the growing interdependence of countries such as New Zealand, Japan, and Australia.

Our Japanese partners bring with them access to the numerous and growing aluminium markets in Japan, which gives us a base to build a smelter large enough to produce aluminium at competitive world prices .....

By welcoming our Japanese partners into this venture we have forged a link between the markets of Japan and the unrivalled resources of hydro-electric power and bauxite of New Zealand and Australia - to the eventual benefit of all concerned." (10)

A Strategy for Successful Asian-Pacific Integration

Much progress has already been made in the improvement of communication between the private sectors of the three advanced western Pacific economies. But most significantly, government information and understanding have failed to keep abreast of Japan's economic relations with Australia and New Zealand in the past ten years. Thus, an important immediate concern of policy ought to be the establishment of an inter-governmental institution staffed by officials from the three countreis. A Japan-Australia-New Zealand Organisation for Trade, Aid, and Development could relay economic information among participating countries, undertake research and advise independently on questions of trade and aid directly affecting member countries. It could act as the prototype for a broader Organisation for Pacific Trade, Aid, and Development. To date, the Australian government has resisted involvement in the kind of official contact that the formation of JANOTAD or OPTAD implies. Maximising the benefits of intra-regional trade in the western Pacific, and of trade between the western Pacific and the rest of the world, now requires some such positive initiative.

OPTAD's first function would be to facilitate the discussion of trade questions and grievances, real or imagined, in a rational and co-operative atmosphere calculated not to damage profitable national trading interests. In this role it would act as a constraint on ever-present protectionist tendencies in partner countries.

OPTAD could give a fillip to joint aid efforts and more generous trade arrangements towards developing countries in the Asian-

Pacific region. The regional approach to the granting of trade preferences to less developed countries has disadvantages. It will be more difficult to reach agreement on the diversion of imports from developed countries to sources of supply in developing countries. In particular, Japan is unlikely to be enthusiastic about preferences on a wide range of labour-intensive manufactures and Australia and New Zealand likewise about preference schemes for primary commodities. On the other hand, and more significantly, Japan, Australia, and New Zealand have been shown to have a greater stake in Asian development than other advanced countries, and together feel most keenly the prevailing aid and trade cynicism. Political economic, and humanitarian benefits deriving from one country's preferences flow in part to the other two developed countries. There is an important divergence between the 'national' and 'global' benefits to developed countreis of granting preferences to less developed countries. Decisions on the granting of preferences taken regionally would bring national benefits closer to global benefits and lead to a higher total level of concessions.

In this context, a worthwhile immediate objective would be for OPTAD to work towards the implementation by all countries of an extension of the Australian preferences scheme. Several features of the Australian scheme are undesirable. One criterion for the inclusion of a commodity is that it is not produced in Australia, thus ensuring a maximum of trade diversion and a minimum of trade creation. The preferences on several items are less than unity. The right to exclude from preference "any developing country which is already competitive in Australia's imports of that product" has been invoked against Hong Kong and Taiwan (3). Quotas are applied to all preference items with the exception of handicrafts, although the quotas have proved to be restrictive in very few cases. Finally, many commodities that are not produced in Australia have not yet been included in the scheme.

However, modest but significant benefits could flow to less developed countries from preferences granted by Japan, Australia, and New Zealand that were mainly (but not entirely) diversionist, and subject to quotas. Such preferences would find readier political assent and could be the precursor of a more comprehensive scheme. And many of the benefits are realised even if quotas are applied, provided quotas are sufficiently generous. The costs of opening a new export market can be high, and are accompanied by high risk and uncertainty. A preferential quota allows a new competitor a wider profit margin on initial sales. By the time the quota is restrictive, the exporter has greater knowledge and will be in a better position to decide whether to expand output and compete over the usual tariff barrier. (9) This 'infant export industry' argument, can also be used to justify the 'non-competitive' countries provision of the Australian preference scheme, although this provision seems undesirable on other grounds and would not be necessary for the political acceptability of the scheme.

One final question arises on policies towards regional preference giving: Should the preferences be granted only to countries in the Asian region, or should they be granted on a global basis? The GATT waiver granted to the Australian preference scheme applied to general preferences. However, because of geographical closeness and existing economic and cultural ties, 87.3 per cent of total preferential imports in 1968 were from the member countries of ECAFE. The benefits of general preferences, including the greater moral pressure they would place on other developed countries in view of the slow progress through UNCTAD, seem to be consistent with Australia, New Zealand, and Japan's special interest in the western Pacific.

OPTAD's third major role would relate to the co-ordination of regional commercial policies. In this capacity it would exert pressure to counteract the effects of autarkic business integration which frustrates efficient regional specialisation. It would identify sectors in which intra-regional capital flows could bring gain and it would smooth the institutional channels for international capital movements. And it would, of course, play an important part in tariff discussions within the region and between the region and other countries.

There is some scope for trading remaining British preferences on non-competitive imports against the relaxation of Japanese import controls on foodstuffs, including meat, dairy products, fruit, and less probably rice. The gains from these concessions would need to be weighed against the possible losses in trade with Commonwealth countries. Investigation of these possibilities and formulating policy on the basis of the results could be an early task of OPTAD.

There is some scope for trilateral bargaining on tariff and import controls, concessions to be granted on a m.f.n. basis. (4) This would certainly have advantages over the unilateral dismantling of high Australian protection on some manufactures that has been advocated. Maximum gain from any concessions would require participation by other countries and OPTAD would be in a stronger position than any one of its members, to put pressure on the Canadian and United States governments for reciprocal concessions. In particular, consultation through OPTAD, with or without reciprocal tariff concessions, would be an efficient way of working towards the sectoral integration suggested by the analysis in the previous section.

There would appear little scope for partial preferential tariff treatment without repediation of GATT membership. Withdrawal from GATT certainly would not be in Japan's best interest. However, as suggested in the discussion of the motor vehicle industry, the North American precedent may allow limited sectoral free trade of a trade creating kind.

Whilst it is almost certinly true that some move towards freer trade would be in Australia's interest at this stage of her economic development, it is extremely doubtful that participation in a limited free trade area would bring net economic benefits. The costs of trade diversion within JANFTA are likely to be high. It would be more useful for the three countries to develop a negotiating bloc for obtaining concessions on a broader front, especially from the United States.

Finally, OPTAD could seek closer contacts with other governments in the Asian-Pacific region. It would place pressure on American governments towards the formation of a broader organisation, just as the Japan-Australia Business Co-operation Committee was a fore-runner to the Pacific Basin Business Co-operation Committee. A more broadly based OPTAD would have objectives similar to those of the origanisation founded by Japan, Australia and New Zealand.

Whether or not a wider Pacific organisation proved possible, a three member OPTAD, with less developed country participation, could be an important instrument for spelling out a positive, non-military, alternative policy in Asia and the western Pacific for the United States.

Notes and References

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Chapter 8

JANFTA and Asian Developing Countries--Sectoral Analysis

I.A. McDougall

I Introduction

The three developed Pacific countries whose seaboards do not also front the Atlantic have for a variety of reasons shown interest in the development of regional trading blocs both in the north Atlantic and the Pacific. Their interest involves political as well as economic motives.

In the case of Japan regional developments could assist in promoting the political stability and economic development of the countries of South East Asia and at the same time facilitate the expansion of the export markets of Japan. Australia and New Zealand also have a considerable stake in the political stability of the area but, in addition, the development of a regional trading bloc is viewed as a means whereby better market prospects may be secured for their temperate agricultural produce and as a way of better ensuring industrial development along the lines of comparative advantage.

It is obvious, however, that the outcome of the recent proposals for the formation of regional free trade groups such as N.A.F.T.A. and P.A.F.T.A. depends upon the result of Britain's application to join the European Economic Community and, much more importantly, upon the attitude of the United States to these proposals. At the moment the official attitude of the U.S.A. could be described only as lukewarm. In the first place, the foreign trade of the U.S.A. is strongly influenced by political factors. However bleak the future of multilateral G.A.T.T. type negotiations may be, it appears that, as long as the U.S.A. retains global political interests it is unlikely to become part of a regional trading group.*

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* This statement may be too strong. Providing a free trade area agreement were sufficiently open-ended and provided that it extended to sufficient countries, the U.S.A.'s interest could be aroused. For instance, in a recent paper D.Robertson is of the opinion that "Whilst no formal proposal has been made by the Administration the possibility of American interest in an Atlantic-based free trade area is not as unlikely as it would have appeared ten years ago" (1, 83 - 84).

If anything the recent Czechoslovakian crisis must have hardened the resolve of the Americans to see established an E.E.C. which is politically as well as economically strong. As long as the participation in the E.E.C. of the United Kingdom is deemed important to ensure this political stability, there seems little likelihood of the U.S.A. proceeding with alternative trade and political strategies.

Finally, in contrast to its global political interests, the U.S.A. has special hemisphere interests which include Latin America. It is inconceivable that the U.S.A. would proceed with the development of a regional trading bloc which did not make special provisions for the republics of South and Central America, Initially these special provisions could be extremely difficult to negotiate unless the interests of other underdeveloped countries and of temperate zone agricultural producers were also considered.

From the viewpoint of Australia, Japan and New Zealand there can be no doubt that their interests are best served the more open-ended and extensive is the free trade area to which they attach themselves, provided always that adequate provision is made for their own special interests.* For this reason the three countries should do what they can to encourage the development of broadly conceived free trade measures both by ensuring adequate discussion of these ideas within their own national frontiers and by assisting in promoting discussion and negotiation at an international level. But while their combined counsels are no doubt important it remains true that any initiative towards the successful formation of a large regional trading bloc must come from the United States. In the meantime, while pressing the case for larger regional developments and for their own special interest within these developments, the three developed and non-American countries of the Pacific might well consider what initiatives they could themselves take to extend trade within the Pacific Basin.

II J.A.N.F.T.A. - A Japan-Australian-New Zealand Free Trade Area

In an earlier article (4) I argued that the establishment of a full free trade area between Japan, Australia and New Zealand was impractical. A number of reasons were cited, such as the extremely sensitive problem of Japanese agriculture and the equally sensitive problem of the protected manufacturing industries of Australia and

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* See (1; 2; 3).

New Zealand. But even if a satisfactory solution to the delicate political aspects of these problems could be found, the remaining uncertainty about the effects of a movement towards full free trade upon the wage levels, unemployment, industrial structures and balance of payments of the member countries would continue to act as a major deterrent. For instance, it is inconceivable that either Australia or New Zealand, who cannot at the moment agree to the full abolition of barriers to trade between themselves, would agree to submit their manufacturing industries to the full blast of Japanese competition whatever the alleged and actual economic benefits of such a move may be.

At the same time there is evidence that the three countries are reappraising the benefits and costs which derive from the continued protection of the above sectors of their economies and that calculated self-interest as well as the tend of events may force them into a gradual, if only partial, abandonment of their protective attitudes. For this reason, I suggested in the paper referred to above that the three countries might consider a move towards free trade by integrating various industries one at a time. This paper considers this proposition in greater detail. First, arguments for and against proceeding with economic integration upon a sectoral basis are discussed. Next, a number of industries are considered in which it is argued integration might well commence. The paper concludes with a number of suggestions about immediate policy.

III Sectoral Integration Reconsidered

The Case for:

Arguments in favour of sectoral integration assume that the removal of distortions in the market for one product will lead to an improved allocation of resources within the area. Quite apart from trade diverting effects, however, there can be no apriori certainty about the effect of the removal of barriers to trade within the group of countries concerned. The problem of 'second best' policies arises and each case must be appraised on its individual merits. But this is, of course, precisely what we are suggesting the three countries might proceed to do. Furthermore, if the long-term intention is to continue to integrate individual industries until a situation of virtual free trade exists these 'second best' considerations are important only in the short-run.

The main argument in favour of integrating the three economies industry by industry is that Governments are more likely to make limited decisions, the results of which can be foreseen with some certainty, because these decisions are known to be acceptable to the respective electorates. Furthermore, the success of integration plans in one industry or group of industries may well provide the stimulus for integration to take place on a broader front. When the European Iron and Steel Community was first contemplated any attempt to bring its potential members into full economic union would have been doomed to failure. When the more narrowly conceived iron and steel agreement showed itself to be not only viable but successful it prepared the way for the formation of the E.E.C. More recently, there is the example of the Canada-United States Automotive Agreement which gave rise to agitation for the integration of other industries such as forest products and/or the chemical industry (5, 2).

The above argument is relevant for J.A.N.F.T.A. because of the particular difficulties involved in making a reasonable estimate of the net gains (or losses) which would follow the complete removal of trade barriers between the three countries. Moreover, one needs know with certainty not only that the area as a whole will benefit from the removal of trade barriers, but that each of the members will also gain. If trade barriers were to be eliminated among the member countries by planned stages substantial changes in the distribution, if not in the level of incomes, would be involved. Because no reasonably sure method exists for compensating any member whose real income may decline or who may be called upon to sustain an undue proportion of the structural changes required, governments might be reluctant to agree to a proposal for full integration. They may not baulk at the lesser proposal for integration upon a sectoral basis where they could bargain for adequate compensation. This then is an argument in favour of integrating more than one industry so that all parties should be seen to gain, but not all industries at the same time. In such a situation the vested interests of one producer group could be played off against those of another group within the same industry or from another industry. Furthermore, each of the member governments would be reasonably sure not only of the prospective net gains but of the likely transitional effects. They would as a result be able to give guarantees regarding compensation to those harmed by the transitional process.

It should be stressed that a proposal for sectoral integration does not imply that any country would cease producing within some industry classification (where this was likely to occur special provisions could be built into the agreement that would retain a share of the industry, if in different form, for the member country concerned). If the E.E.C. has proved anything it is that the structure of modern industry involves extreme specialisation in the production of inputs and outputs within each sector itself. Ideally, therefore, integration provides not merely a large market, but the opportunity to develop a high degree of input specialisation within the market area of the respective industry.

Another advantage of sectoral integration is that trade diversion and adverse terms of trade effects could be more accurately predicted and where necessary steps could be taken to minimize these effects. For instance, if it were the automobile industry which was being integrated harmful trade diversion effects could be prevented by reducing barriers to trade in automobiles with non-member countries.

So far we have been discussing established industries. Yet another attraction of the sectoral approach is that it would facilitate a more rational development of the science-based industries of the future whose location need not be left to historical accident. Moreover, the capital outlay required to establish these industries is too large for any small or medium size country. There is much to be said, therefore, for a group of smaller countries pooling their resources for development purposes.

Benefits which could be obtained from the formation of a full free trade area are to a greater or lesser extent also likely to be present if the three countries proceed with integration on a sectoral basis. Despite its faith in the multi-lateral principles of G.A.T.T. the U.S.A. has shown itself prepared to subordinate its trading principles to its political objectives. Without doubt one of its major political goals is to establish a group of non-communist countries in South East Asia which are stable politically and economically strong. Japan, Australia and New Zealand share the same political goal.

For this reason, the development of P.A.F.T.A. being blocked by the U.S.A.'s global commitments, and the establishment of a full free trade area between Japan, Australia and New Zealand being impractical for the reasons cited above, it would seem likely that the U.S.A. and indeed the U.K. for similar reasons might give enthusiastic encouragement to a more limited sectoral project providing it remained open-ended and providing it was meant to increase the effectiveness of aid and development programmes in South East

Asia. We shall return to these points below. Here, we need merely reiterate that the extensive trade relations of the three potential member countries with the United States and with the United Kingdom make it essential that these two countries give any integration project their active backing in the diplomatic negotiations which would precede an agreement. Enthusiasm for such a scheme is not considerable as yet in the potential member countries and not only would the gains need to be seen clearly but the blessing of the two powers mentioned would be required if the scheme were to be implemented. All this, of course, presupposes that as far as the United Kingdom is concerned her application to join the Common Market remains unsuccessful. Should the United Kingdom enter the Common Market then her attitude to New Zealand and Australian participation in a free trade area project with Japan would not be of such importance because Commonwealth preferences would no longer be a live issue.

There are other than political reasons why Japan, Australia and New Zealand should contemplate seriously any scheme which would augment economic growth in the underdeveloped nations of the South East Asian area. From Japan's point of view these countries provide a market for exports second only in importance to the United States. In 1967 the countries of South East Asia took 28 % of Japan's exports and were her most important customer for heavy industrial and chemical goods exports. But there are two problems which could jeopardise future Japanese exports to the area. The preponderence of heavy industrial and chemical goods partly reflects conditional aid and reparations payments made to these countries by Japan. This is becoming increasingly concerned about the growing surplus in her balance of trade with these countries (in 1967 they provided only 15 % of her imports). The continuing success of Japanese exports to this area depends upon successful economic development and for this reason Japan must welcome any scheme which, among other things, would lead to the co-operation of the developed nations of the Pacific Basin in promoting economic growth in the area.

Apart from political and humanitarian considerations, Australia and New Zealand are also interested in the economic development of South East Asia because the successful development of the area could provide important markets for the agricultural exports which dominate the export baskets of the two countries. Of late their attention has been turning increasingly to the area and they are mindful that countries such as South Korea and Taiwan, whose national incomes are growing so rapidly, could follow the Japanese pattern of changing dietary habits and increased demand for western-type foodstuffs. By themselves they are too small to do other than make a token gesture to assist development in the area but they would obviously welcome an opportunity to participate with other countries in a development programme which made better use of their specialist resources and at the same time brought them into increasing contact with the commercial life of these areas.

At present the allocation of aid to South East Asia is low on a per capita basis. In 1964 it was $2.55U.S. per capita compared with $4.20 for Latin America or $6.20 for Africa. Japan has made it abundantly clear that her own financial position is not sufficiently strong to undertake more than a moderate share of the increased flow of aid that is required in the area and that she looks to other countries for their co-operation and assistance.

A free trade area, commenced upon a sectoral basis between Japan, Australia and New Zealand, could assist in several ways. First, while the combined aid programme of the three countries would be quite inadequate,in relation to the needs of the area, it would make for a more effective aid programme than if the three countries were to continue to act unilaterally. As an offshoot of the trade agreement a combined aid programme could be developed which could better combine the specialist resources of the three countries. For instance, in the field of agricultural development both Australia and New Zealand could make important contributions in the way of technical assistance and training and this could be combined with Japanese capital to establish agricultural research and training centres, model farm developments and food processing industries.

While the U.S.A. and other countries such as Canada may decline to participate in a Pacific free trade area, they may be willing to formally associate themselves with or to at least co-operate with any aid programme that developed along with the trading agreement. There would be nothing inconsistent about this.

A sectoral trade agreement between Japan, Australia and New Zealand could also facilitate the granting of trade preferences to the countries of the area. It could do this by extending preferential treatment in the industries integrated to the underdeveloped countries of the area. Combined with carefully conceived aid and investment (to which the Asian Development Bank might contribute) such a scheme would provide for a more rational industrial development than that which is based upon a policy of import substitution.

In some circumstances preferential treatment could also be extended in industries in which integration had not occurred.

An objection which could be made about such a regional (and sectoral) preference system is that it conflicts with schemes for the multi-lateral granting of privileges and that this would arouse the opposition of the United States. Two points should be noted. First, in lieu of international agreement about the granting of preferences to the underdeveloped countries on a multi-lateral basis such a scheme as outlined above does provide an opportunity for those countries which can agree to proceed with a more limited preference scheme. Secondly, I am at a loss to understand why countries can agree to the giving of aid on a discriminatory basis (presumably for political or balance of payments reasons) but cannot agree to the granting of discriminatory trade preferences. If anything, the two fit nicely together in that the aid may provide the capital equipment for industrial development while the granting of trade preferences, if wisely done, will ensure a more rational choice of industries for development.

The Case Against:

A major objection to a proposal for sectoral integration is the incompatability of the proposal with the General Agreement on Trade and Tariffs (G.A.T.T.). The basic underlying principle of the GATT is the most favoured nation rule as a result of which tariff concessions granted to one country are passed on to all other GATT members. The well-known exception to this rule is where a group of countries form a customs union or free trade area and within which it is the intent of the members to remove substantially all barriers to trade within a specified time period. No provision whatever is made for a proposal which includes only a small number of products. GATT being the cornerstone of Japan, Australia and New Zealand's international trading policy this would appear to be a major difficulty.

In the past, however, GATT has made no fundamental objection to similar schemes and one can cite the instance of the E.C.S.C. and of the more recent Canada-United States Automotive Agreement for which both Canada and the United States successfully applied for a GATT waiver. There is also the New Zealand-Australia Free Trade Area Agreement which has been approved by GATT but within which the two countries are moving slowly towards free trade on a sectoral basis.

In the lull which has followed the recent Kennedy Round negotiations members of the GATT are more kindly disposed towards alternative schemes for the freeing of international trade than they have been in the past. What is important is the intent of any new proposition. If it is open-ended so that other countries can later seek membership and if it is the intention merely to commence by freeing trade in one or two sectors before proceeding to other sectors then the suspicions of fellow GATT members are likely to be allayed. In other words what matters is whether the scheme is envisaged from an international viewpoint as a trade creating one or as a thinly disguised proposal for regional discrimination against the goods of third parties.

Possible GATT objections could be avoided if the three countries were prepared to adopt an M.F.N. rather than preferential basis in their approach to the sectoral freeing of trade. This, however, would require Japan, Australia and New Zealand to extend non-reciprocal free trade privileges in the sectors concerned to all third parties and it is unlikely that the three countries would agree to this proposal. In the first place, whatever the economic arguments may be, it would be difficult politically to win acceptance for the idea that a 'free ride' should be given to third parties. Secondly, it would make it more difficult to provide for a pattern of industrial development other than that determined by market forces. For instance, the recent Canada-United States Automotive Agreement contained provisions about market shares which ensure that Canada will continue (in fact will increase) its share in automobile production for the North American market. It is extremely unlikely that either Japan, Australia or New Zealand would proceed with an integration project unless, at least for an initial period, similar guarantees were made. This last objection would not hold if industries could be found in which, even with virtual free trade, the contribution of third parties to the market area was negligible. However, with the possible exception of meat and dairy products, there are no such industries.

Finally, we need consider a major criticism which is particularly relevant when the M.F.N. proposal is considered. One basic condition for the success of free trade within selected industrial sectors would be to ensure fair competition in the production and marketing of the products concerned within the market area. Obviously, this requires the removal of restrictions in addition to tariffs and quotas.

The problem of securing competitive conditions is accentuated where a commodity is traded freely but when the principal inputs such as raw materials, component parts or capital equipment are protected. One example of this is to be found in the Canada-United States Automotive Agreement where Canadian automobile producers correctly pointed out that while their imports of capital equipment from the U.S.A were subject to Canadian import duties they could not be expected to compete adequately with their American competitors in the United States market (5, 4).

All this suggests that a proposal for free trade in the outputs of any industry or industries needs be extended to the various inputs of the sector concerned. Inevitably, this would widen the scope of any agreement and make it more difficult to secure the co-operation of the affected industries, some of which may be less than enthusiastic about the whole proposal. But the negotiating and administrative difficulties would be increased even further if the free trade area were to be formed along M.F.N. lines as suggested above. Moreover, once inputs were included in the projected scheme it is certain that no industry could be found in which the contribution of third parties to the Japan-Australia-New Zealand market area was negligible.

Even if reascnable progress could be made on a preferential basis towards removing fiscal and legel impediments to trade between the three countries there is further barrier to fair competition which needs consideration. Foreigners have often complained that business parctice and the high degree of concentration of business in Japan provide additional obstacles to the successful functioning of competitive forces. In part there is substance in this accusation in that the highly integrated nature of the Japanese economy does lead to a firm within particular groups of firms - such as Mitsui or Mitsubishi - being granted discriminatory treatment. In part these problems which confront a foreign competitor in Japan also arise from an inadequate understanding of business conventions in Japan. Thus, while not minimizing the difficulties raised by the high degree of integration of Japanese business, part of the remedy lies in an increased understanding of business practice in Japan and of the functioning of the Japanese economy.

A further impediment to the success fo a sectoral free trade scheme is the attitude of the Japanese Government to foreign investment in Japan. To some extent the success of the proposal would depend also upon the free flow of capital within the industries selected for free trade. Of the three countries, Australia actively encourages foreign direct investment within Australia and

New Zealand's attitude is only slightly less liberal. Japan's restrictionist policy is based primarily on the fear that if a freer inflow of foreign capital were allowed a large part of Japanese industry would come under foreign control.

Japan has been criticised strongly by her trading partners for her failure to remove the controls over foreign capital inflow. As a result some concessions have been made and for those industries in which the Japanese are technologically advanced or only slightly less so than their foreign competitors, foreign ownership can now range between 50 % and 100 % for any one firm (although it may not exceed 20 % for the industry as a whole). Where the industry concerned is deemed to be technologically backward, however, any inflow of foreign capital to a firm within the industry is carefully vetted. Yet it is precisely in these areas that foreign investment could be seen to do the most good both from the point of view of Japan and the foreign investor. For instance, Australia and New Zealand have an interest in the processing and distribution of temperate zone agricultural products.

There is evidence that Japan intends to proceed further with her liberalisation policy (6; 2, 57) and that the process could be formally completed by 1971 (2, 28). The problem is certainly not an intractable one as far as a proposal for free trade between Australia, Japan and New Zealand is concerned. Capital would be free to flow in a north-south direction and while it would no doubt retain its right to continue to vet foreign investment in 'sensitive' areas, Japan could be expected in time to facilitate a mutually satisfactory two way capital flow.

The establishment of preferential treatment among the three countries for the flow of capital, inputs and outputs of certain selected industries could provoke strong criticism from the other trading partners of the three countries. Much would depend upon the industries selected for integration and upon the resulting trade-diversion effects. As far as Japan is concerned, even if these were not large there might be strong opposition from United States business interests. At the present time United States business is keenly aware of Japanese competition within the American market and resents the Japanese controls not only over foreign investment but also over free trade in such products as automobiles in which Japan is rapidly increasing export sales. In these circumstances preferential treatment extended to Australia and New Zealand could give rise to requests for discrimination against Japanese goods in the United States market. As noted above, however, the official attitude of the United States may be that small economic losses (and these could be short-term if Japan continues to liberalise her trade relations) are a worthwhile price to pay for the chance of increased political stability in the South East Asian area. From Australia and New Zealand's point of view it is the attitude of the United Kingdom which would be most important and we have already commented upon this problem.

IV. The Need For Industry Studies

There are a number of industries which could be considered for inclusion in a sectoral free trade agreement between Japan, Australia and New Zealand. In each case what is required is a detailed investigation of the likely impact of a freeing of trade upon the ownership, wage rates, productivity, employment and composition of output in the industry concerned. In no way can the present paper pretend to offer this type of exhaustive and quantitative enquiry. Instead a few suggestions are made about industries which might profitably be investigated in this manner. What is important is that the integration of the industries selected should be seen to offer obvious advantages for the three countries.

The Automobile Industry

The automobile industry is one which might be considered. Despite import duties levied on motor cars and despite the presence of other fiscal devices which discriminate in favour of the Japanese automobile producer, Japan is the second largest producer of motor vehicles in the world. Although the industry might be inclined to argue otherwise, there can be little doubt that this protection is today superfluous and that the Japanese car industry is fully competitive by world standards.

The same can be said for neither Australia nor New Zealand. Production of cars and commercial vehicles in Australia is running at approximately 400,000 per annum and is expected to rise to 500,000 per annum by 1970. At the present time domestic production has a 60 % to 70 % share of the market in Australia. A recent report on the Australian economy (7) showed that there were fourteen firms producing motor vehicles in Australia. Of these six were manufacturers and assemblers and eight were exclusively engaged in assembly. Government policy is to increase still further the Australian content in motor vehicle built or assembled in the country and the 1970 objective is for an Australian content of 95 % for passenger-type vehicles.

To achieve this objective a high level of protection is accorded the industry. Complete vehicles are subject to a 35 % M.F.N. rate while the rate of duty levied on components varies from 35 % to $52\frac{1}{2}$%.

Despite a highly competitive situation as between different producers within Australia there can be no dount that extensive protection from overseas competition and the demand of the public for a wide range of motor vehicles has made it possible for a relatively large number of firms to survive.

A much worse situation exists in New Zealand. There the industry is concerned only with assembly and assembles approximately 80,000 vehicles per annum of which the domestic content is about 40%. Current government policy is to increase the domestic content still further.

At the moment there are ten firms operating seventeen plants which turn out forty to fifty different car models. Even if one excludes the smaller firms the average number of vehicles per firm is approximately 8,000 vehicles. Needless to say this state of affairs is maintained in being by a mixture of import licencing controls and tariffs. The M.F.N. tariff rate on new vehicles is 55 % and on components 45 %. Rigidly applied import licencing controls make it difficult to assess what the real cost of protection is. A recent World Bank report, however, suggested that to increase the present domestic content from forty to fifty per cent would cost around 300 % of the marginal savings of imports.

In these circumstances the introduction of free trade with Japan would probably eliminate the New Zealand motor vehicle assembly industry and bring about a considerable re-structuring and consolidation of the Australian industry.

Whatever the economic benefits are alleged to be it is unlikely that either Australia or New Zealand would accept a proposal for the complete, if gradual, removal of barriers to trade in motor vehicles. The political realities of the situation suggest that any free trade area proposal would initially need contain provisos regarding market shares if it were to have any chance of success. But even this type of proposal, which is similar to the Canada-United States Automotive Agreement and which is a proposal for selective industrial integration rather than for free trade, has a great deal to commend it compared with the present situation. By the removal of margins of preference accorded Commonwealth imports it would direct demand to a cheaper source of supply for both finished vehicles and for components. It would also lead to a restructuring of the automobile industry in both Australia and New Zealand in a manner that would result in a large reduction of firms and to rationalisation schemes whereby each country reduced the domestic content of the vehicles it assembled but increase or commenced the export of components to one another as well as to Japan.

If this proposal were to be of benefit to Japan any agreement about the retention of market shares need increase Japan's share of the Australian market. To some extent this would occur at the expense of third parties, particularly if both Australia and New Zealand were to retain their present tariff levels with regard to the rest of the world. To some extent, however, it should be achieved by offering the domestic industry a guaranteed minimum share that was less than its current share. For instance, in 1966, of the passenger cars supplied in the market area as a whole Japan supplied 71 %, Australia 17 %, New Zealand 2 % and the remainder were supplied by third parties (9). An agreement which guaranteed New Zealand and Australia minimum shares of say 12 % and 1½ % of the market would on 1966 figures have given Japan an opportunity to increase her sales of motor cars to Australasia by up to 184,000 vehicles. This would be equal to approximately 20 % of the production of motor cars in Japan in 1966.

The objections to such a scheme are many and obvious. To the extent that the increase in Japanese sales was at the expense of third parties (and to the extent that the trade of these third parties was not due to Commonwealth preference) Australasia would be purchasing from dearer sources of supply. There would also be the danger of retaliation on the part of the third parties affected but this is a difficulty which must be contended with in forming a free trade area.

Perhaps the most damaging criticism is that the huge negotiating and administrative effort which would be involved in initiating the scheme may outweigh the benefits to be derived from it. By itself such a scheme would have only a marginal effect on real incomes in the countries concerned and its justification must ultimately be its demonstration effect. If, as in the case of the European Coal and Steel Community, it gave rise to broader and bolder integration measures it may prove worthwhile.

<u>Coal, Iron and Steel Industries</u>

Japan and Australia are fully competitive by world standards in the production of iron and steel. In both countries the virtual absence of protection or of controls over capital flows suggests that free trade in this sector already exists. Japan is a major exporter of steel and Australia is a small net exporter; Australia is also a net exporter of iron ore and of coal while Japan relies heavily upon imports of both of these raw materials.

It is probable, however, that there is scope for further rationalisation of the coal, iron and steel industries in the two countries. In Australia some fabricated items continue to receive protection. For instance, pipes and tubes are subject to an M.F.N. duty of 35% and for these and related products the elimination of barriers to trade would enable Japan to capture a larger share of the market. Furthermore, in what is an extremely capital-intensive industry, there would appear to be no reason why Japan should not establish steel making plants within Australia. This could not only improve competitive conditions within Australia where the industry is dominated by one Australian owned firm and its subsidiaries but could also lead to a greater specialisation in production of steel in each of the two countries.

From the viewpoint of New Zealand much could be gained from participation in some type of free trade area agreement for iron and steel products. At the moment New Zealand is establishing an iron and steel industry which will make use of local coal and iron sand deposits. Recent technological break-throughs suggest that the industry could be competitive even on an international basis if it were not for the decision to attempt to produce a wide range of merchant products in order to make New Zealand virtually self-sufficient in steel production. The cost of such autonomy is certain to be short and extremely high-cost production runs which in a few hours will provide a six months supply of New Zealand domestic market requirements.

In these circumstances there is much to commend a scheme which may ensure the retention of a minimum market share for New Zealand but which would enable the industry to focus its attention on one or at most two basic types of merchant products, the surplus production of which over and above domestic requirements it would export to Japan and/or Australia. New Zealand would rely upon these two countries for the supply of her remaining domestic requirements.

Meat and Dairy Products

It would seem that a minimum requirement for the participation of Australia and New Zealand in a free trade arrangement with Japan is that in return for their granting of concessions in trade in industrial products Japan should respond by liberalising imports of agricultural products in general and of meat and dairy products in particular. The last two categories of agricultural produce still account for approximately one sixth of Australia's export receipts and for about three fifths of New Zealand's export earnings. I am aware, of course, of the seemingly intractable nature of the agricultural problem in Japan but I am also of the opinion that a number of developments are going to make a rethinking of agricultural policy in Japan not only desirable but inevitable.

Those factors which have made agriculture the most sensitive area of trade policy in Japan have both political, social and strategic overtones. Politically, all Governments in Japan in the post-war period have depended considerably upon the support of the rural electrorate and although the proportion of the workforce engaged in agriculture has fallen dramatically from 40 % in the mid 1950's to 23 % in 1967 this political factor remains important. Socially, many Japanese contend that the maintenance of the rural way of life makes for stability at time of rapid change in the other sectors of the economy. Strategically, Japan is concerned lest she becomes too dependent upon imported foodstuffs - she already imports about one fifth of her total food requirements.

To preserve the rural way of life a number of policies have been adopted. While encouragement is being given to modernisation by means of research expenditure, by the teaching and demonstration of better farming techiques, by fostering the use of fertilisers and by urging farmers to concentrate their small farm holdings into larger units, the industry is also protected from the effects of competition by a combination of policies such as import quota, tariffs, production subsidies and price support schemes. The result has been not only high but rising food prices. For instance, the price of rice is more than double the world price and its retail price has risen by over 80 % since 1960. Prices of meat and dairy products, the per capita consumption of which has been rising very rapidly, are also extremely high. Milk is approximately $ 0.30 U.S. a pint and beef prices range from $ 1.25 U.S. a lb to around $ 7.00 U.S. a lb for prime quality beef.

Despite the high prices of foodstuffs various import demand projections that have been made by the Food and Agricultural Organisation and by other Japanese organisations indicate a steady rise in consumer demand and in import requirements. In the case of meat and dairy products these projections indicated that by 1975

Japan will be importing 2.1 million tons of raw milk equivalent in dairy products and approximately 480,000 metric tons of meat (which compares with import demands in 1966 of 0.4 million tons of raw milk equivalent in dairy products and of 140,000 tons of meat). If anything these projections are excessively conservative in that they have accepted national production plans which, particularly in the case of dairy products, show no likelihood of being realised. For instance, to achieve the 1970 production target the rate of increase in production of dairy products in Japan would need be trebled.

There are good grounds for arguing that it would be in the long-term interests of Japan if she were to revise her present agricultural policies. Short and long-term projections for the development of the Japanese economy (6) stress the importance of attaining a high rate of export expansion if the planned increases in per capita incomes are to be achieved. The long-range plan indicates among other things that exports will need to expand at 9.2 % per annum if a per capita increase in real incomes of 7.1 % per annum is to be attained.

In part this continued export expansion must continue to depend upon the diversion of labour from low-productivity agriculture to the export industries and upon the ability of Japanese industries to retain a competitive edge in export markets. In the period 1960 to 1965 the single major contributory factor to the rise in the cost of living of 6.2 % per annum was the persistent rise in food prices (8) (whose sub-group within the index rose at 8.4 % per annum). It would appear, therefore, that Japan is pursuing policies which are inconsistent. On the one hand, a rapidly expanding level of per capita incomes is dependent upon a high rate of increase of export receipts which is in turn dependent upon a continuing flow of labour from the agricultural to the industrial sector and upon price stability in the domestic market. On the other hand, a policy of agricultural self-sufficiency, with supply held back by low productivity and a declining agricultural labour supply and with demand for high protein foodstuffs increasing at around 10 % per annum, must result in further substantial price increases.

While Japan is most unlikely to expose her farmers to the full blast of international competition there are grounds for arguing that the negotiation of a limited free trade agreement in agricultural products with Australia and New Zealand could be in her best interests. Such an agreement could guarantee Japanese meat and dairy producers a minimum share of the domestic market. They could be assisted, for instance, by a system of subsidy payments similar to those made to British farmers by the United Kingdom Government. In this event, tariffs and import quotas on Australasian farm products being removed, the prices of meat and dairy products would fall and the consumption of them increase cosiderably. An alternative scheme, which would be less attractive to the Japanese consumer and to the New Zealand producers but which would be more attractive to the Japanese Government, would be to retain a tariff on imports of meat and dairy produce (but to abolish all quotas) and to make use of the tariff revenue to assist in subsidising the Japanese producer. That New Zealand and Australian farmers would receive no margin of preference over third party producers would not matter providing the tariff levels set made for an increase consumption of meat and dairy products and providing provisions were made to prevent the dumping of surpluses.

The advantage of such schemes from the viewpoint of Australia and New Zealand is obvious. From Japan's point of view the success of these schemes would depend upon who subsidised the Japanese farmers and upon the share of the market it was felt expedient to reserve for them. As a political force the influence of the rural electorate will continue to decline. By 1985, for instance, less than 10 % of the total workforce is expected to remain in agriculture.

In the meantime if the Japanese Goverment were to finance the subsidy scheme this would be a further charge upon the taxpayer. But cheaper food prices would appeal to an increasingly influential urban electorate and the contribution of rising food prices to the overall rate of inflation would be checked. If anyting, the diminishing importance of the rural electorate and the higher taxes required to finance farm subsidies would increase the urgency of the programme to modernise farming. It is also possible that Australia and New Zealand could be called upon to contribute financial and technical assistance to accelerate the increase in productivity in the farming sector.

Conclusion

In the absence of detailed quantitative investigations it is difficult to reach any firm conclusions about whether it would be worthwhile to proceed on a sectoral basis to free trade between Japan, Australia and New Zealand. Unfortunately, the more limited is an agreement to extend trading relations the more protracted and costly can be the negotiations and the administering of the agreement reached. However, the more likely are such limited measures to lead to more liberal steps being taken to remove the barriers to trade, the stronger becomes the argument in favour of them.

It appears that the best way to institute trade arrangements of this sort between the three countries would be for Japan to become a member of the New Zealand-Australia Free Trade Area Agreement which has been in force since 1965. The stated purpose of the Agreement is to promote "a sustained and mutually beneficial expansion of trade .... under conditions of fair competition".

The Agreement stipulates that there will be a progressive reduction and elimination of duties on all the commodities listed in Schedule A of the Agreement. The general requirement is that once goods have been included in the schedule they will immediately become free of duty if subject to a prior tariff of less than 5 %, that they will become free of duty in two years if subject to prior duties of 5 - 10 % and that if subject to prior duties in excess of 10 % goods will become free of duty over eight years.

There is nothing, however, which is automatic about the inclusion of goods on the Schedule and specifically excluded are those "goods the inclusion of which would be seriously detrimental to an industry in .... either Member State ...." Further safeguards exist which permit action to be taken against dumped and subsidized imports and which allow for the temporary withdrawal of concessions if serious injury could be done to domestic producers, if a balance of payments crisis confronts one of the members or if the Member State decides to encourage a new enterprise. To date, therefore, the effect of these safeguards has been to develop the freeing of trade on a sectoral basis.

Whatever one might like to say as an economist about the desirability of these safeguard clauses the fact is that an institutional framework exists within which a freeing of trade on a sectoral or other basis could take place if the Member States are of serious intent. Furthermore, there is provision within the Agreement for the inclusion of other countries. Thus, at a point in time when there are not many commodities included on the Schedule to the Agreement, it should not prove difficult to negotiate Japan's entry.

To surmount those difficulties which would arise and to provide the information upon which policy decisions could be based, the three countries should establish an advisory committee. This committee should make detailed reports upon those industries which might be profitably included on Schedule A to the Agreement. It could also investigate the possibility of extending preferences to some of the underdeveloped countries and the possibility of the three countries co-operating in a foreigh aid programme. Its reports on these and related matters could provide the basis for further discussion of the issues involved at the diplomatic and business level.

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COMMENTS ON P. D. DRYSDALES'S AND I. A. McDOUGALL'S PAPERS BY HISAO KANAMORI

Dr. Drysdale's paper shows clearly that trade among Japan, Australia, and New Zealand is highly intensive, either because of high degrees of complementarity in trade or because of the geographical, political, and historical closeness among them. His analysis of the structure of trade among these advanced western Pacific countries seems to suggest that policies designed to promote closer integration between Japan on the one side, and Australia and New Zealand, on the other side, would be beneficial.

Several factors have to be taken into account in assessing the desirability of integration among these three countries. Drysdale's paper and McDougall's paper both deal with these factors. Among them, three questions are of particular interest.

First, is the establishment of a complete free trade area among Japan, Australia, and New Zealand desirable and practicable? Drysdale's conclusion is that it is "extremely doubtful that participation in a limited free trade area would bring about economic benefit. The costs of trade diversion within JANFTA are likely to be high." He suggests that it would be more useful to undertake limited integration and develop a negotiating bloc for obtaining concessions on a broader front, especially from the United States.

Whether the establishment of a complete free trade area among the three countries is desirable remains unclear to me, largely because the dynamic effects of such an arrangement have yet to be analysed fully. Whilst Drysdale's analysis of the static effects is plausible, his interesting analysis of the dynamic effects is still in progress. Whatever the results may be, a complete free trade area is unlikely to be feasible. McDougall draws attention to the extremely sensitive problem of Japanese agriculture, and there is the equally sensitive problem of protected manufacturing industry in Australia and New Zealand. Drysdale draws attention to other problems. I agree with their conclusion.

Second, is sectoral integration desirable and practicable? Drysdale discusses the possibilities for sectoral integration in three industries - motor vehicles, iron and steel, and non ferrous metals - and he appears to come out in favour of the sectoral approach towards integration. As far as his analysis of pig iron production and aluminum production is concerned, I agree that sectoral integration is not only desirable but possible. Benefits from the minimization of transport costs and intensive use of high quality resources specific to one part of the western Pacific region cannot be denied. Drysdale's suggestion that the realization of these benefits will be facilitated by joint ventures and business tie-ups is particularly interesting. The fact that this kind of joint-venture arrangement has already been negotiated within the aluminum industry confirms its practicability. But with respect to motor car production, the prospect for agreed specialization seems doubtful. Drysdale suggests that it would be rational for Japan to specialize in the production and export of small and small - medium sized passenger cars, and for Australia to specialize in the production and export of medium sized cars. I admit that economies of scale are important in the motor vehicle industry. But I do not think that it will be possible to agree on specialization. The effect of economies of scale seems too uncertain to persuade businessmen in Japan to abandon medium sized car production. McDougall's view that "whatever the conomic benefits are alleged to be it is unlikely that either Australia or New Zealand would accept a proposal for the complete, if gradual, removal of barriers to trade in motor vehicles," seems correct.

McDougall urges sectoral integration or rather the removal of Japanese restrictions, in the meat and dairy industries. Contrary to opinions generally expressed, he seems rather optimistic about the prospects for freer access to Japanese primary commodity markets, arguing that "while Japan is most unlikely to expose her farmers to the full blast of international competition, there are grounds for believing that the negotiation of a limited free trade agreement in agricultural products with Australia and New Zealand could be in her best interests. I am of the opinion that a number of developments are going to make a rethinking of agricultural policy in Japan not only desirable but inevitable." I am in agreement with McDougall on this point. Agricultural protectionism in Japan is losing ground not only from an economic viewpoint but also from a political viewpoint. Increased consumer prices due to agricultural import restrictions and the higher taxes required to finance farm subsidies, as well as the growing strength of the urban over the rural electorate, suggest the inevitability of modification to Japan's agricultural protectionism.

Third, what should be the relationship between Japan-Australia-New Zealand and the Asian developing countries? Drysdale points out that "there is a strong case for coupling any policy initiatives by advanced countries with the extention or adoption of trade policies specifically designed to accommodate the needs of developing countries in the Asian-Pacific region." Since the Asian developing countries are shown to have high complementarity and high special country bias in their trade with both Japan and Australia, this point assumes special significance.

Moreover, it seems to me that triangular trade among Japan, Australia, and Asian developing countries may become more important than direct trade between Japan and Australia, because of the growing labor shortage in Japan, the development of labor intensive industry in Asian countries, and the growth of capital and resource intensive industries in Australia and New Zealand.

COMMENTS ON P. D. DRYSDALE'S AND I. A. McDOUGALL'S PAPERS BY H. W. ARNDT

The theme of this session is "JANFTA and Asian Developing Countries" but the Asian Developing Countries have hardly figured in the two papers except for Dr. Drysdale's interesting extension of his trade intensity analysis to selected Asian developing countries and his comments on a possible widening of the Australian less developed country preferences scheme. I wonder, incidentally, would Dr. Drysdale reconsider his judgement that Australia's trade intensities and special country biases in trade are generally high with Asian developing countries? It seems that, in her import trade with Asia, special country bias is high with Indonesia alone, and that is due entirely to the special nature of trade in oil.

I should like to focus the discussion more on the Asian developing countries and begin by asking again Dr. Kitamura's question: is PAFTA going to be a rich men's club, an OECD of the Pacific? Does it have any significance for the Asian developing countries except (like the OECD) in relation to aid?

Let me begin by referring back to a point raised earlier by Professor Lockwood: What contribution can trade liberalization make to the economic development of the Asian developing countries? Clearly we cannot generalize. The Asian developing countries differ greatly from one another in their stage of industrialisation. Some, like Hong Kong, Taiwan and recently Korea, have shown that spectacular expansion of exports of manufactures are possible without any preferences. Others, like Indonesia and Burma could not take any advantage of freer access for exports of manufactures for many years to come. For Indonesia industrialisation, when it once again gets under way, will for years to come concentrate on import substitution. For others, like India, preferences may be crucial in the next few years.

Trade liberalization and "free trade areas," moreover, seem to mean very different things to different people round the table. Professor Kojima's PAFTA has almost nothing in common with Dr. Kitamura's free trade area for the developing countries of ECAFE. The former is thinking of freer trade between the advanced countries, the latter between developing countries. More important, while Kojima is interested primarily in trade liberalization and envisages "planned structural adjustment" mainly as an aid to this process, Kitamura dismisses trade liberalization as of marginal significance and thinks primarily in terms of planned industrial development in which "agreed specialization" is part of a regional strategy of import substitution. It merely confuses the discussion to sweep these differences under the carpet.

Again, even among the supporters of PAFTA there would seem to be a marked difference of emphasis between those who assume that, given time, structural adjustment will come spontaneously as the response of market forces to opening up of new trade opportunities in a free trade area, and those who think a good deal of government planning will be necessary. Clearly, if the latter view is right, PAFTA will be a much more difficult proposition for countries like Australia, or the U.S.A. for that matter, which generally eschew direct government planning and control of the private sector than, for example, for Japan. This is another difference that might be worth some discussion.

DISCUSSION

DISCUSSION OF PAPERS PRESENTED BY L.V. CASTLE, P.D. DRYSDALE AND I.A. McDOUGALL

In reply to comments on his paper, Professor Castle said that he had not meant to over-emphasize the importance of the British connection in preventing Australia and New Zealand from participating in Pacific area trade arrangements. It was one factor which had, however, to be reckoned in the benefits and costs. Certainly for Australia it would be quite wrong to suggest that it was a very important factor. As Dr. Drysdale has shown in his paper, there has been a remarkable shift in the whole pattern of Australia's trade away from Britain. Australia has also gone very much further in the reorientation of attitudes of mind. New Zealand has proceeded in the same direction, but more slowly. Professor Castle agreed with Professor Chough that the tendency in New Zealand to want to wait-and-see whether the United Kingdom gained admission to the EEC had a negative effect on New Zealand's trade policy. In fact, it was largely responsible for her failure to take up promising opportunities elsewhere, especially in Japan.

Professor Castle also envisaged the growth of a stronger export-oriented manufacturing sector in New Zealand. He pointed out that there had been an 80% growth in manufactured exports since devaluation, with heavy concentration of that growth in Asian-Pacific markets.

Finally, Professor Castle said that he had not meant to imply that global free trade should be the major focus of OPTAD. Like its original proponent, he understood that the major focus would be on trade relations between Japan, Australia, and New Zealand, and on trade relations between those countries and countries such as Taiwan and Korea, which might well be welcomed to membership when they desired it. Its main interest would be in the Pacific, and, for that reason, an expanded OECD would not serve as an adequate substitute.

In reply to comments on his paper, Dr. Drysdale said that he had pointed out in his paper that there were very few circumstances under which integration among the motor vehicle industries in advanced western Pacific countries might prove feasible. However, should the American industry's attempt to enter directly into production in Japan be rebuffed, it is just possible that a basis for negotiating more effective western Pacific specialization might emerge. The big American producers in the Australian industry might, under those circumstances, become receptive to the idea of pushing c.k.d. or fully built-up exports to Japan from their Australian base, and the Japanese industry might find this preferable to American production in Japan. Dr. Drysdale suggested that it was worth thinking about this particular set of circumstances right now. He added that he did not think that it would be necessary to negotiate agreed specialization in the sense Mr. Kanamori had in mind - involving the agreed cessation of medium-large car production in Japan and small car production in Australia. That would not be necessary to the success of an arrangement of the kind suggested. The aim was to eliminate the inefficient tails of each country's industry; but firms which had achieved volume in small car production in Japan and medium-large car production in Australia would undoubtedly be able to maintain less efficient production of large cars in the former case, and smaller cars in the latter case, at the same time. There would be substantial real income gains for large proportions of the population in both countries and for the whole region for which they are dominant suppliers of motor vehicles.

Dr. Drysdale suggested that a large part of his paper had been devoted to a detailed analysis of Australia's economic relations and trade policy towards Asian developing countries. His analysis of the static effects of trade liberalization also included an assessment of the effect of non-reciprocated trade concessions towards Asian developing countries. As to the question of the closeness of Australia's trade relations with ECAFE countries, and particularly those selected for close analysis, he stressed that his comments on the generally high degrees of intensity were relevant principally to export trade with the region. Care needs to be taken in the interpretation of the analysis. The fact is that seven out of the nine countries selected reveal high special country biases in this export trade, and six reveal high intensities. The selection is not biased: 16 percent of Australia's total exports went to the whole ECAFE region plus New Guinea in 1968, a region which only accounted for around 6 per cent of total world imports in the same year. That implies high trade intensities, and special country biases since complementarity can be taken as reasonably low, with the region as a whole.

Dr. Drysdale agreed that the provision of trading opportunities for developing countries was only one of the problems to be tackled. But recognition of that is no excuse for not trying to devise policies aimed at providing more trading opportunities for the important group of developing countries which require them. In this matter, something can be done unilaterally, as the Australian example has shown, and a whole lot more could probably be done regionally. Negotiations among the interested advanced countries and between them and developing countries on trade matters might encourage more generous direct economic assistance for those that need it as well. He concluded that, if the theory implicit in what was said in the paper about the effect of trade preferences turns out to be generally relevant, then there is a strong case for linking the two activities together.

Discussion of the three papers revolved around questions about the nature of JANOTAD or OPTAD and the role they might play in regional development; the importance of Japanese agricultural protectionism on the one hand, and Australian and New Zealand manufacturing protectionism on the other; and the GATT constraint on limited integration of the kind suggested by Dr. Drysdale for western Pacific motor vehicle industries and by Professor McDougall for other sectors.

Participants from Japan, Australia, and New Zealand emphasized the importance of an identification of interest in the Asian-Pacific region. It was argued that an organization such as OPTAD could provide the framework for a move towards freer trade and economic relations among the advanced countries in the region in the same way as the OECD did for Europe in its time. However an important difference was noted - the development problem looms much larger in the Pacific and Asia. It was felt in consequence that there would be much greater stress on the development problem in the evolution of institutional arrangements within the Pacific. Participants from developing countries and developed countries alike urged the importance of providing a framework for a dialogue between the advanced and developing countries on matters of aid and trade policy within any such organization. There were some who then wondered whether a duplication of the function of ECAFE might result. Others pointed out that the principal initiatives and concerns in the organization proposed would derive from the three or five advanced Pacific countries - they would have certain definite policy goals in mind, such as the negotiation of trade concessions among themselves, the extension of trade preferences, and co-operation in aid-giving, and those would bear little relation to the work of ECAFE. It was felt that regional endevours in this direction would yield more than unilateral or bilateral endeavours. One participant argued that the formation of a three-country organization, with developing country participation might have an added, immediate advantage as a strategy for holding the line against growing American protectionism. Whilst it seemed unlikely, as Mr. Lea suggested in an earlier paper, that the United States would become involved in the general imposition of quotas, equally it seemed possible that she could become involved in directing quotas against particular suppliers. Australia had already suffered. Of the quota requests before Congress, more than one third were levelled at Japan. United States quotas against Japan would directly affect the economic welfare of Australia, New Zealand, and Asian developing countries.

Questions were also raised about the extent to which modification of Japanese agricultural protectionism might prove possible in the negotiation of trade concessions among Japan, Australia and New Zealand. A Japanese participant observed that whilst the economic benefits of reduced protection were clear, their realization might require some basic reform of the Japanese electoral system in which one rural vote counted for about three or four urban votes. Some participants thought that economic and political pressure would weigh more and more heavily against Japanese agricultural protectionism and that, in any case, income growth would provide a substantial market for Australia's and New Zealand's agricultural exports. Others stressed the important residual problems of escalating effective protection with increasing differentials between domestic and international policies, and the adverse substitution effects of these price differentials. As for the possibility of modifying manufacturing protectionism in Australia and New Zealand, a New Zealand participant saw promise in the development of a specialized manufacturing sector in each country with substantial manufactured exports. For New Zealand, forest products, pulp, paper, carpets, and engineering products were cited as viable export industries. There did not appear much promise, on the other hand, for competitive production of the standardized, run-of-the-mill manufactured commodity which usually required prior production for large domestic markets. An Australian participant said that there had already been some pressure towards modification of Australian protectionism and the development of a more efficient, export-oriented manufacturing sector. To date, this pressure had not focussed on the negotiation of reciprocal consessions but had been reflected in calls for the closer scrutiny of Australian tariffs alone.

Finally, an American participant suggested that it might not be so easy to obtain a waiver from GATT for sectoral integration of a discriminatory kind. He pointed out that political considerations had dominated the granting of a waiver for the European Coal and Steel Community in 1952 - the importance of welding former U. S. allies and enemies together - and that, whilst the Canadian-United States Automobile Agreement offended against the letter of GATT law, it did not offend against its spirit. Others felt that the

New Zealand-Australian Free Trade Area, which in practice allows for the freeing of trade by sectors, provided a contra precedent. In any case, some of the important proposals contained in the papers involved m.f.n. tariff concessions, and it was thought that in other cases it might be possible to organise quid quo pros. Moreover, some felt that political considerations might not prove entirely irrelevant.

Part Ⅳ

COOPERATION WITH RESPECT TO MONEY AND CAPITAL MOVEMENTS

Chapter 9

INTERNATIONAL MONETARY COOPERATION IN ASIA AND THE FAR EAST

Robert Triffin

Introduction

My only claim for distinction at this conference is my utter incompetence as an area specialist on the problems of Asia and the Far East. This incompetence limits severely the contribution which I can realistically hope to bring to your discussions. It bars me from raising and exploring the most concrete problems of intra-Asian economic and monetary relations as such, and forces me to confine myself to a different set of problems which are nevertheless of crucial importance to this area and with which I can claim a modicum of familiarity, *i.e.* the impact of broader, worldwide trends on Asian and Far Eastern international monetary developments, and the consequent need for an "agonizing reappraisal" and "aggiornamento" of international monetary policies and institutions more and more divorced from the current and prospective realities of economic and political life in this area of the world.

I shall, first, outline briefly two such worldwide trends, of enormous importance to these, as well as to other, countries in the days and years ahead:

1. The accelerating disintegration of the so-called "gold-exchange" standard; and

2. The rewarding postwar development of closer regional cooperation, or even integration, of monetary and economic policies and institutions in various parts of the world.

I shall then turn to two of the specific policy responses that Asian and Far Eastern countries might develop to adjust to these developments:

1. The gradual shaping-up of an Asian or ECAFE Reserve System; and

2. The opportunities which such a system would offer for a mutually profitable expansion of trade relations and for the acceleration of economic development in the area.

I. The Disintegration of the Gold-Exchange Standard

Recurrent sterling, dollar and gold crises have amply and dangerously confirmed, in recent years and months, the diagnosis presented, many years ago, by a few isolated academic economists, regarding the increasing instability and ultimate unviability of the gold-exchange standard.

Needed reserve creation was fed--increasingly haphazardly--under this system, from two sources, neither of which bore any relation to the economic requirements for reserve increases necessary to sustain feasible and non-inflationary rates of growth in world trade and production. The first of these sources was monetary gold, i.e. the amounts of gold which central banks could, and did, buy from the market at $35 an ounce, to absorb the excess of current gold production and unpredictable Soviet sales over and above the amounts absorbed by dentists, jewelers, industrial users, hoarders and speculators. The second was the "gold-convertible" foreign-exchange balances--primarily dollars and sterling--which became available to central banks as a result of American and British balance-of-payments deficits, and which these central banks would prefer to retain in the same form--in order to earn interest-rather than to convert them--for safety sake--into sterile gold metal.

Both of these traditional sources of reserve increases have not only dried up. Their flow has even reversed itself, destroying--rather than creating--reserves through the drain of gold from reserves into private channels and the liquidation of sterling and dollar reserves previously accumulated by central banks. The traditional gold-exchange standard is therefore dead, and beyond any realistic hope of being revived by the international monetary doctors.

Gold

Gold reserves accounted for about 91 percent of world reserves at the end of 1937, but only for 42 percent of reserve increases over the years 1938-1949, 26 percent in 1950-64, and minus 51 percent from January 1, 1965 through June 1968 (see first line of Table 1).

The central banks of the former gold pool have reluctantly and belatedly confirmed the death of gold as a major source of future reserve increases. France having defected already from the gold pool in the previous summer, its seven remaining members terminated and buried the pool at their March 16-17, 1968, meeting in Washington. They decided to hoard their remaining gold stocks by stopping sales

Table 1

Sources of Reserve Creation: 1938-June 1968

	Annual rates, in millions of U.S. dollars			Percentages of Total Reserve Creation			
	1938-49	1950-64	1965-June 1968	Before 1938	1938-49	1950-64	1965-June 1968
I. Gold	573	589	-641	91	42	26	-51
II. Credit-Reserves	776	1676	1891	9	58	74	151
A. Negotiated	148	430	2476	-	11	19	198
1. Reserves in IMF	148	181	703	-	11	8	56
2. Foreign Exchange	-	249	1773	-	-	11	142
B. Other Foreign Exchange	629	1246	-585	9	47	55	-47
1. £ Balances of £ Area			-536				-43
2. Other			-49				-4
Total Gross Reserves	1349	2265	1250	100	100	100	100

Sources and Notes:

1. These estimates are uniformly derived from the International Financial Statistics (October 1968 and annual Supplements) Tables on "International Liquidity" and U.S. and U.K. "External Liabilities" and from Federal Reserve Bulletin March and September articles on "Treasury and Federal Reserve Foreign Exchange Operations."

2. "Negotiated Foreign Exchange" (line II A 2) is a minimum estimate, including only (a) outstanding U.S. swap liabilities and "nonliquid" liabilities to foreign official agencies and (b) post-1963 sterling reserves of the U.S., Canada and Western Europe (except Iceland and Ireland), minus a rough estimate of sterling reserves of these countries not linked with the so-called Basle agreements on special central bank assistance to the U.K.

3. "Other Foreign Exchange" (line II B) also includes, however, balances affected by negotiations and informal agreements, particularly as concerns the sterling balances of the sterling area (line II B 2) on which more formal agreements were negotiated in the summer of 1968.

Brief Comments:

Note the declining role of Gold (line I), the fast increasing role of credit-reserves (line II), and particularly of "negotiated" credit-reserves (line II A), and the decreasing pace of Gross Reserves increases after 1964.

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to the private market and to any central bank that would continue to sell gold to the private market. They also agreed, however, that they saw no need to buy gold in the future either from the market or from current gold production.

If adhered to in the future, this double-barrelled decision would therefore block any further increase, as well as decline, of the monetary gold stocks. I would venture the guess, however, that the short-term policies forced upon central banks by the March panic cannot in fact--and indeed should not--be indefinitely enshrined as a sensible and viable long-term solution of the problem.

The minimum shift of policy that can confidently be predicted at this time is that central banks and/or the international Monetary Fund will resume gold purchases if and whenever the price falls perceptibly below \$35 an ounce. The amounts of such purchases, however, are unlikely to be very large. Available supplies from current production (\$1.4 billion to \$1.5 billion a year) are now, it is true, well in excess of "legitimate" industrial and artistic demand (estimated at about \$800 million a year in 1967) and traditional, nonspeculative, "hoarding" demand (which I would put around \$300 million a year, i.e. the lowest amount of private purchases recorded in any of the last twenty years but two and not accounted for by industrial and artistic demand). Barring new gold discoveries, however, gold production is likely to decline gradually over the years if the gold price does not rise, while industrial and artistic demand is currently increasing by more than 10 percent a year. Industrial, artistic and traditional hoarding demand might thus be expected to catch up with--and later exceed--current production within a span of three to four years from 1967, i.e. by about 1971.

Speculators are well aware of these projections and are therefore unlikely to unload their own hoards--large as they are now--on the market at any price lower than \$35 an ounce. They might even continue to push the price up either in anticipation of its unavoidable increase in the long run, or because of their obstinate expectation that repeated governmental assertions that the official gold price will not be changed are a clear indication that such a change is actively contemplated and migh indeed be decided in the very near future.

The March 17, 1968 decisions are indeed a manifestation of deep-seated differences, rather than agreement, among major gold holders regarding its future role in the international monetary system. It would be impossible to explain rationally otherwise the contrary motivations that might justify this simultaneous refusal to buy gold, even at less than $35 an ounce, and to sell it, even at prices widely in excess of $35. It is hard to believe that central banks could remain totally indifferent to the price of a commodity of which they hold $40 billion of idle stocks and which is still strongly viewed in many countries -- no matter how mistakenly -- as the indispensable backing for public confidence in the national paper currencies issued by the same central banks.

If speculators were nevertheless deterred by the March 17 decisions to seek for security in gold, they would continue to switch assets from the more exposed currencies of deficit countries to the "stronger" currencies of surplus countries, such as Germany. Gold speculation would then abate only to be channeled instead into currency speculation, as or more dangerous to the stability of the international monetary system.

Viable long-term policies regarding the role of gold in the international monetary system will thus have to be defined within the very near future. Protracted inability to reach joint agreement in this respect, at least among the major reserve-holding countries, would be bound to lead, sooner or later, to disparate, mutually defeating national decisions that might end up either in gold revaluation or in a breakdown of the international monetary system between a gold bloc and a dollar bloc. Fortunately, the growing awareness and fear of such an outcome are now stimulating more promising efforts than have even been elicited in the past to reach a sensible agreement acceptable to all participating countries. Before discussing the possible shape of such an agreement, however, I must now turn to the second source of traditional reserve creation, *i.e.* the accumulation of foreign exchange balances --primarily dollars and sterling--as a normal component of international reserves.

Foreign Exchange

Under the gold-exchange standard, the accumulation of foreign-exchange as international reserves was left to the spontaneous decisions of central banks, influenced by the earnings available on this type of reserve component--but not on gold--and by the firm expectation that any balances so accumulated could easily and readily be converted at any time into gold-metal, at an established and fixed official price, upon simple request to the debtor of such balances.

The death of this system has become increasingly, and disturbingly, evident to central bankers, and even to interested laymen, all over the world. It can be read in the increasing proportions of foreign exchange now held only as the result of bilateral, or multilateral, pressures or negotiations. The exact figures are difficult to quantify in view of the secrecy surrounding some at least of these transactions. Yet, a broad order of minimum magnitude can be guessed at, with reasonable certainty, by using the techniques described in the Note accompanying Table 1 above and expanded in the Note to Appendix Table 3. In brief, we can certainly regard as "negotiated" holdings:

1. the reserve claims accumulated on the IMF;

2. the reserve claims expressed in the so-called outstanding "swap" commitments of the Federal Reserve System;

3. the other dollar reserves accumulated in the form of "Roosa bonds" and other so-called "nonliquid" obligations of the United States to foreign central banks;

4. the sterling reserves accumulated in the course of the rescue operations repeatedly negotiated ever since 1964 through the various "Basle agreements."

A cursory glance at Appendix Table 3 shows that the "negotiated reserves" of the North Atlantic area (i.e Western Europe, the United States and Canada) have more than tripled in the last four and a half years (1964-June 1968) while their "traditional" foreign-exchange holdings dwindled at an accelerating pace over the same period. The former have increased by \$8.8 billion, while the latter have declined by \$3.5 billion (2nd column of Table 3).

The estimates given in the same Table for the "rest of the World" are less clear and reliable. The large increase in "unrecorded" foreign exchange -- i.e. the difference reported in International Financial Statistics between reported assets and reported U. S. and U. K. liabilities -- is difficult to explain and throws serious doubts on the reliability of the estimates. Secondly, foreign exchange holdings listed as "traditional" have certainly been subject also to various, more or less formal, agreements, especially for the sterling holdings of the sterling area. In any case, the new sterling agreement announced at Basle last September now make most of these holdings "negotiated" holdings and clearly reflect the intention of all parties to reduce drastically -- if not to eliminate completely -- the reserve currency role of sterling.[1]

A Negotiated Credit-Reserve Standard

The broad conclusions that emerge from this brief factual review are that

1. Gold is most unlikely to feed any substantial portion of future reserve increases, unless its price is -- contrary to rational expectations and official pronouncements -- sharply increased as an accidental result of some new crisis;

2. Barring such an "accident" future reserve increases will continue to be fed primarily by the expansion of credit-reserves which already account today for 47 percent of global reserves, as against 9 percent in 1937, and for more than 150 percent of the reserve increases of the last three and a half year.

3. The growth of credit-reserves, however, is no longer

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1 It should also be noted that the dollar as well as the sterling reserve holdings of most undeveloped countries are largely held with the New York and London banks which extend to these countries' residents credits whose amounts are linked to the willingness of the central banks to retain their own reserves with the lending banks.

taking place under the spontaneous -- and always reversible at any time -- decisions of central banks implied in the theory of the "gold-exchange" standard. "Unnegotiated" foreign - exchange reserves have been decreasing at a fast pace in recent years, their place being taken by "negotiated" foregin exchange holdings and reserve claims on the Fund under a new emerging "negotiated credit-reserves" standard. (See Table 1, above, and Appendix Table 3.)

The continuation of this evolution is dependent on a vast expansion of the IMF lending power over future years, such as is now contemplated and organized in the proposed Amendments of the International Monetary Fund Charter and the deliberate creation of Special Drawing Rights as a normal component of world reserve increases.

The agreement reached so far in this respect, however, will have to be modified and supplemented, in order to be fully workable in the long run and even to ward off new and dangerous crises in the short run:

1. The automatic distribution of SDR's among all Fund members pro rata of their Fund quotas is unlikely to prove workable in the long run, as it would:

(a) allocate -- largely as gifts -- 36 percent of the new SDR's to two of the richest countries in the world (the United States and the United Kingdom), another 36 percent to twenty - three other developed countries, and only 28 percent to the poorest eighty-six less developed countries of the world;

(b) contradict the cardinal principle, so often proclaimed and reaffirmed by the international monetary negotiators, that the deliberate creation of international reserves should be linked to a strengthening of the adjustment mechanism;

(c) expect prospective creditors to underwrite blindly in advance--through quinquennial SDR allocations--policies of prospective debtors in which they have no voice and which they may regard at times as totally contrary to their own, or to world, interests.

Future decisions to activate the SDR system are most likely, therefore, to prove extremely difficult to negotiate if the allocation system is not amended to take account of these objections. The lending potential derived by the IMF from the prospective creditors' commitments to accumulate SDR credit-reserves will have to be used for purposes internationally agreed by the participants, rather than for the blind underwriting of national--and potentially conflicting--national policies. Such internationally agreed policies would include, for instance:

(a) traditional IMF, stabilization loans;

(b) compensatory financing of disequilibrating, but reversible capital movements between major money centers, as foreseen in the IMF "General Arrangements to Borrow."

(c) IMF support for commodity stabilization schemes, such as foreseen in the second resolution unanimously adopted at Rio, in September 1967;

(d) indirect financing--through the IBRD, IDA, etc.--of economic assistance to the developing countries as long advocated by UNCTAD and a number of academic, business and government economists, and by the Reuss Subcommittee on International Exchange and Payments (see, for instance, the Reuss and Ellsworth Report of December 1965, and the Subcommittee's Report of December 1967).

The acceptance of such a "link" between reserve creation and development financing was opposed by the Group of Ten on the ground that short-term liabilities cannot be used properly for the financing of long-term investments. They were clearly wrong in extrapolating what is a correct taboo for commercial banks to a world institution whose need for liquidity would arise only, as sarcastically noted by Professor Machlup, from a still remote need for "interplanetary" settlements. The Group of Ten has now apparently accepted that view, since the Rio Agreement foresees that 70 percent of the SDR's used need not impose any repayment obligations, and can thus be regarded as potential gifts. If short-term liabilities can now be used to finance permanent gifts, they should certainly be usable to finance long-term investments.

2. Actual needs for SDR creation cannot be gauged, particularly for advance five-year commitments, in the absence of agreement regarding the future role of gold and reserve currencies in the process of reserve creation and reserve destruction. Liquidity needs would be amply met--or even overmet--and bar therefore any requirement for supplementary SDR creation if foreign central banks resumed in the future large accumulation of dollar and/or sterling balances arising from U.S. and U.K. deficits, or if a change in speculators' expectations prompted vast disgorging from the enormous gold hoards accumulated by them in recent years. Conversely, persistent U.S. and U.K. deficits--or political bickering between the U.S. and/or the U.K., on the one hand, and the main dollar and/or sterling holders, on the other--might trigger, at any time, massive liquidation of dollar and/or sterling balances and threaten a collapse of the present system.

Academic and other proposals for the setting up of a so-called "Conversion Account" or "Reserve Settlement Account" are designed to meet these problems and avoid de-stabilizing switches between reserve-currencies and gold. These proposals were, until recently, regarded by a majority of the oficial negotiators as "unnegotiable" with the United Kingdom and particularly the United States, or at least as "premature." The climate of official opinion has now changed, however, partly as a consequence of the willingness--and even eagerness--of the United Kingdom to relieve sterling of its reserve currency role--now regarded as a "burden" rather than the "exorbitant privilege " denounced by de Gaulle--and of the unanimous support of the U.S. Joint Economic Subcommittee on International Exchange and Payments for such an approach to the current gold and reserve-currencies problems and recurrent crises (see the Subcommittee's Report of September 18, 1968).[2]

The speeches of the Managing Director of the Fund and particularly of Governor Colombo of Italy, at the October 1968 annual meeting of the Fund, confirm other indications that these problems and suggestions will be actively explored in the forthcoming months, both by the Group of Ten, and by the IMF Staff and Executive Directors.

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2 For my own version of these proposals, and their contribution to the implementation of any jointly agreed gold policy of members, see the Subcommittee's Hearing of September 9, 1968, pp.143-147, and Our International Monetary System: Yesterday, Today and Tomorrow (Random House, 1968) pp. 146-164.

II. The Trend Toward Regional Monetary and Economic Integration

The evolution outlined above of the international monetary system from the former "gold-exchange" standard to an emerging "negotiated credit-reserves" standard would, however, place new and immense burdens upon the management and policy-making machinery of an otherwise unreformed IMF. These burdens might be lightened through the development of a more decentralized and better structured system of international monetary cooperation, building up on the growing trend toward regional monetary, financial and economic integration in evidence in Western Europe (the European Economic Community and the European Free Trade Area), in Latin America (the Central American Common Market, Central Banks' Clearing House, Central American Monetary Union Agreement, and Latin American Free Trade Area), in Soviet Europe (the Comecon, the Council for Mutual Economic Assistance and the International Bank for Economic Cooperation) and in recent discussions about trade and financial integration in the United Nations Economic Commissions for Africa and for Asia and the Far East.

The spectacular success already achieved along these lines by the EEC and Central America (the near quadrupling of intra-EEC trade, for instance, since 1956 and the near sextupling of intra-Central American trade since 1960) is understandably stimulating interest in other areas for similar policies. The acceptance and implementation of trade liberalization commitments, however, have also proved to be closely linked with, and dependent on, parallel agreements on mutual financial assistance and gradual harmonization of internal, as well as external, monetary and economic policies. Such agreements can be negotiated more easily among small groups of neighboring countries than at the worldwide level, and are essential to the survival and success of long accepted goals of regional economic integration.

It is increasingly realized in the EEC, for instance, that the mutual assistance provisions of the Rome Treaty (Article 108) are less formal and binding than the commitments already accepted by its member countries toward the IMF, even though the economic commitments that they are supposed to underpin are for more ambitious than those undertaken by them in the worldwide framework of the Fund. Various proposals for closer monetary integration, and even for an eventual merger of the EEF currencies into a signle currency, have received considerable attention and support, including even an affirmation, in September 1967, by the then Chancelor of the Exchequer, Mr. Callaghan, that Britain would consider sympathetically such a merger of sterling itself within a common European currency.

Actual progress, however, has remained slower than anticipated. One of the reasons for this has been that the large and persistent deficits of the United States and the United Kingdom have, throughout most of the young EEC's lifetime and until a few months ago, relieved its member countries from any serious pressures on their balance of payments. All of them were accumulating surpluses and reserves, obviating the need for closer harmonization of policies within the Common Market itself, and diverting attention instead to recurrent sterling, dollar and gold crises and the reform of the international monetary system.

Such a reform may now be anticipated in the near future. There is little doubt that it will require a more decentralized and better structured world monetary system, easing the awesome management problems that it will impose upon world monetary cooperation and facilitating, incidentally, the eventual reintegration of the COMECON group into such a system.

Bureaucrats and even policy makers, however, are forever inclined, by tradition and profession, to resist institutional changes that disturb the routines and habits of mind to which they are accustomed, and whose consequences cannot be fully foreseen in advance. This is true in Asia today as it was in Europe and in Central America during the debates that preceded and accompanied earlier steps toward regional integration.

It is pointed out, for instance, that most Asian countries carry more trade with countries outside the region than within the region itself, that some are far weaker than others economically and financially and would prove unworthy partners in any such arrangements, that--conversely--the less developed countries of the area could not open up their markets without exposing their "infant industries" to unbearable and unfair competition from the more developed participating countries, that political rifts between aligned and non-aligned countries, between India and Pakistan, etc. would bar in effect any real cooperation among them, etc., etc.

All this perfectly true, but it was equally true in Europe and Central America, and did not prevent the success of these two major precedents in regional integration. The proportion of intraregional trade to extraregional trade was hardly larger at the outset in EEC than in the ECAFE region and very much lower indeed in Central America. Objections were also raised in Europe about the mingling of weaker countries--such as Greece and Turkey--with stronger countries--such as Belgium and Germany--in OEEC, EPU and the Association Treaties with the EEC. As for political obstacles, they were as great, or greater, in Europe and Central America as in Asia. Germany was deeply hated, in the late 1940's and early 1950's, by the countries which had been invaded and occupied by it during the two world wars. Border porblems between Nicaragua and Costa Rica were exacerbated by the basically opposite racial and political structures of these two countries: one purely white and with a long democratic tradition, the other primarily Indian and ruled, for many years, by a militaristic and despotic plutocracy.

Regional economic integration in Asia would indeed tend to make such hardcore problems more, rather than less, manageable. Members would, in time, become less dependent than they are today on divisive alignments with rival powers outside the region. Fruitful forms of cooperation between Pakistan and India could be negotiated more easily as part and parcel of broader regional commitments than they ever could on a bilateral basis.

Many of these arguments for a "do-nothing" approach to the Asian problems should indeed be viewed as strengthening the case for a positive approach seeking their solution, or at least their alleviation, in the development of mutually beneficial economic and monetary cooperation among the countries of the area.

III. An Asian or ECAFE Reserve System

The ECAFE countries, like all other countries, must, and do, earmark substantial resources to the maintenance of an adequate level of international monetary reserves. These have increased steadily from a low of $5.3 billion at the end of 1958 to $8.2 billion, as of last June, i.e. at an average rate of about $300 million per year (see Table 2).

These reserves are by no means ample. They correspond to about 25 percent of the area's annual imports, as against 36 percent for the non-Soviet world at large and 40 percent for the non-ECAFE countries. The reserves of Australia and New Zealand are proportionately higher (35 percent), but those of Japan far lower (17 percent) than those of the other ECAFE countries (28 percent), and these, in turn, are lower than those of the other less developed countries taken as a group (34 percent).[3] The announced intention

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3 See Table 3.

Table 2

Composition and Evolution of ECAFE Countries' Gross Reserves, 1958-1967
(in millions of dollars)

End of	1958	1959	1960	1961	1962	1963	1964	1965	1966	1967
I. Gold	935	1107	1124	1155	1244	1265	1312	1380	1333	1424
Australia and New Zealand	195	188	182	163	191	209	227	231	224	232
Japan	54	244	247	287	289	289	304	328	329	338
Other Asia	686	675	695	705	764	767	781	821	780	854
II. Reserves in IMF	80	207	248	243	329	371	406	449	609	543
Australia and New Zealand	8	48	73	31	105	131	131	135	170	205
Japan	62	125	125	180	180	180	220	253	321	239
Other Asia	10	34	50	32	44	60	55	61	118	99
III. Foreign Exchange	4273	4876	4929	4756	4969	5741	5647	5583	5941	5910
Australia and New Zealand	1089	1231	824	1263	1234	1645	1714	1262	1269	1127
Japan	946	1077	1577	1199	1553	1589	1495	1569	1469	1454
Other Asia	2238	2568	2528	2294	2182	2507	2438	2752	3203	3329
IV. Global Reserves	5289	6185	6300	6156	6546	7374	7360	7411	7882	7873
Australia and New Zealand	1293	1466	1077	1457	1530	1985	2072	1628	1663	1563
Japan	1062	1447	1949	1666	2022	2058	2019	2152	2119	2030
Other Asia	2934	3272	3274	3033	2994	3331	3269	3631	4100	4280

Source: "International Liquidity" Tables of International Financial Statistics (November 1968, pp. 15-18).

Notes:

1. "Other Asia" includes here Iran, shown under "Middle East" in IFS.
2. Slight discrepancies in totals are due to rounding-off of some IFS estimates to next $5 million.

of Japan to increase very substantially its own reserves over future months and years (they have already risen by nearly 20 percent in the third quarter of 1968) might be expected to increase the reserves of the ECAFE group as a whole.

External reserves unavoidably entail opportnity costs--measurable in terms of lower internal consumption and/or investments for the reserve holders--and exchange risks. The latter have risen sharply with the undermining of confidence in the reserve currencies in which the area holds most, by far (73 percent), of its gross reserves.[4] The holding of one's reserves in national currencies inevitably exposes the holders to exchange risks--devaluation--as well as to other political risks--blocking--and subordination. Any massive switches from reserve currencies into gold would probably prove unfeasible at this juncture, in view of the reactions which could be expected from the reserve currency debtors--primarily the United States and United Kingdom--when confronted with any large gold drain from their already depleted gold reserves. In any case, the intensity of the present international monetary crisis and the possible reactions to it on the part of the United States and many other countries might undermine seriously the future role of gold as a safer and preferred reserve and settlement asset.

Table 3
Reserves, Imports (millions of $) and Reserve Ratios (in %)

	June 1968 Reserves	1967 Imports	Reserve Ratios
Australia and New Zealand	1671	4818	35%
Japan	2001	11664	17%
Other Asia	4485	15826	28%
ECAFE	8157	32308	25%
Other Countries	64888	170000	38%
Developed	55933	143900	39%
Less Developed	8955	26100	34%
World Total	73045	202300	36%

Source: International Financial Statistics, November 1968, pp.16, 35 and 37.

The proposed SDR's will, if and when created, offer, on the whole, the safest and most appropriate investment in which reserves should be held. Their supply, however, will be

4 See Table 2, line III divided by line IV.

severely limited at first, and will grow only slowly over the years. The creation of an "International Conversion Account" or "Reserve Settlement Account" might accelerate the availability of internationally guaranteed reserve deposits, but agreement on such a system is still highly hypothetical at this stage.

In any case, whether guaranteed or not, SDR or "conversion account" reserve holdings would still entail the investment of reserves outside the region itself, the extent to which they are reinvested in the region remaining dependent on outside decisions in which ECAFE reserve holders would have a voice, but only a minority one.

It is possible to conceive of a different reserve mechanism that would reduce the risks involved in the present system of reserve holdings, decrease the present financial and political subordination of ECAFE reserve holders toward the reserve center countries, and, last but not least, enable them to divert toward the ECAFE area itself some of the resources now put entirely at the disposal of non-ECAFE reserve centers?

I have prepared, at the request of the ECAFE, concrete proposals that would meet these objectives, and which need not be rehashed here.[5] In brief, I suggested that a modest portion--to be increased, in the light of experience, over future years--of participating countries' gross reserves be held in the form of interest-earning and exchange-guaranteed deposits with a Central Reserve Fund. The Fund, in turn, would be directed by members--and by its charter itself--to retain in gold or appropriate investments in the major financial centers a portion of its total assets (equal to its deposit liabilities) sufficient to guarantee beyond any question the ready availability and usability of its deposit liabilities for all balance-of-payments settlements outside as well as within the region. The balance of its deposits, however, could be invested within the region to support policies agreed by its members or defined in the Charter itself. (The latter would be confined, in my proposals to <u>automatic,</u> but modest and medium-term stabilization assistance to countries faced with deficits in their <u>overall</u>--rather than in their intraregional--transactions.)

The rationale of these proposals is discussed at length in the

5 See <u>Report and Recommendations of the Seminar on Financial Aspects of Trade Expansion</u>, ECAFE, Bangkok, 20 September 1967, particularly pp. 127-206.

document referred to above, and only some salient points will be covered in the brief outline that follows.

First of all, interest earnings on Reserve Fund deposits could clearly be larger than on alternative direct reserve investments in the present world reserve centers. The Fund's earnings on the portion of its assets retained in such investments would be slightly higher because some of them could and should be invested with maturities somewhat longer than those appropriate for reserve investments by anyone of its members countries (the reason being that the global balance-of-payments deficits of the group as a whole --and therefore the maximum size of withdrawals needed to finance them--are nearly inevitably far smaller than the sum of individual countries deficits, some--and usually most--of the latter being off-set, and often more than offset, by the surpluses of other members.[6] Earnings would be even higher, of course, on that portion of the Rund's assets that would be invested within the area itself, since this would by-pass the intermediation profits now derived by New York and London banks from the relending to area residents of deposits maintained with them by the same area's central banks.

Secondly, legally accepted exchange risks could be decreased in relation to those now legally incurred on direct dollar and sterling investments. They might not be entirely eschewed on the portion of the Fund's assets retained abroad, although the centralization of such operations might strengthen the bargaining power of the area in this respect. Loans and investments to area members, however, would obviously be denominated, not in the borrower's national currency, but in a unit of account designed to provide exchange-guarantees acceptable to members.

Alternative definitions of such a unit of account should be carefully considered. A sterling or dollar definition would, of

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6 The reserve losses of individual ECAFE countries over the period 1959-66 totalled close to \$2.8 billion, the sum of annual reserve losses ranging from less than \$100 million (in 1959 and 1966) to nearly \$750 million in 1961. The net reserves of the group as a whole, however, <u>rose</u> by more than \$2.6 billion over the period as a whole, and by \$400 to \$900 million in four of those eitht years, global reserves losses occurring in only one of those years (1961) and being confined in that year to \$128 million only. See Table 3 and the ECAFE <u>Report</u> ... mentioned above, Table 10, pp. 172-173, last three lines.

course, be easier since it would conform to market habits and traditions and was, until recently, regarded by members as safe and acceptable. Sterling, however, has now lost this status, as recognized in the sterling area greements negotiated last summer and giving a dollar-value guarantee to the bulk of members' sterling holdings. A dollar-value guarantee may, however, appear itself questionable in view of the present international monetary turmoil. On the other hand, a gold-value guarantee might legitimately be regarded as unacceptable by prospective borrowers, and its legal significance increasingly uncertain in view of the divorce now created between the official and the market gold price, and of the possibility that major countries might be forced, at some time, to suspend the gold convertibility of their currency, thus leaving only the private gold price as a criterion for a gold-value definition.

The most logical solution to these problems and uncertainties would be the adoption of an international, or regional, unit of account similar to that which served, with outstanding success, the European Payments Union for more than eight years, and has been imitated in recent years for the flotation of "unit-of-account" obligations on the international capital market.

It will be observed, thirdly, that the legal rights and commitments of members might be put in jeopardy by any significant default on the part of the Fund's borrowers. The Fund's Charter, however, could erect more powerful and effective barriers against such defaults than any ever conceived in international lending operations in the past. This could be achieved through a simple provision committing all members to channel any gross payments due to a defaulting member through that member's deposit account with the Fund until the full amount of the default has been cleared.[7]
Of course, negotiations would probably, in practice, obviate actual

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7 In the course of the ECAFE discussions referred to above (p. 15, footnote 1), the eventuality of full default by Indonesia, under the hypothesis that my proposals would have been put into operation, was raised by several of the participants. I looked at the data presented in my paper (penultimate line and column of Table 13, p. 182 and 5th column of "Indonesia" line of Table 1, p. 160) and pointed out that the $5 million maximum default of Indonesia would have been wiped out in less than a week if other members had channelled through the Fund their settlements of Indonesian exports to them, reported as $265.6 million per year.

resort to such a clause, but it existence would strengthen considerably the position of the creditors toward the defaulting country, and its observance would not be dependent on the word of the latter, but on that of all other members and their interest in safeguarding the value of their own claims on the Fund.

Fourth and foremost comes the ability of the Fund to guarantee the full availability of members' deposits for all balance-of-payments settlements, outside as well as within the region.

Intra-regional settlements could not, of course, create any problem in this respect, since they would merely lead to a reshuffling of the Fund's deposit liabilities among members--debiting the account of the payer and crediting that of the payee--without affecting in the least the total assets (= liabilities) of the Fund.

Problems could arise only in connection with settlements outside the region, but would not necessarily arise even then. As long as the group of participating countries, taken as a whole, remained in equilibrium, or better still--as has been the case in all years but one over the period 1958-1967--in surplus with the outside world, any withdrawals of foreign currencies by some members would be matched, or more than matched, by additional deposits of foreign currencies by other members. The Fund should be forced, however, to retain a sufficient portion of its total assets in foreign currencies --or gold--to finance any conceivable withdrawals even in the event that members, as a group, experience global deficits and reserve losses toward the outside world.

As may be gauged from line IV of Table 2 above this happened only once over the last ten years, in 1961, and was confined to a reserve drop of $144 million, or 2.3 percent of members' global reserves totalling $6300 million at the end of 1960. If this were taken as adequate evidence of future risks, the Fund would not need to retain more than an insignificant fraction of its assets in foreign investments, and could invest the bulk of them (97.7 percent) within the region. This would, of course, be unadvisable, but it is clear that compulsory foreign reserves of 3/4, 2/3, or even 1/2 of its total deposit liabilities (= to global assets) would be ample to cover any conceivable risks, thus enabling the Fund to invest the remainder (up to 1/4, 1/3, or even 1/2) of its assets within the region itself.

This is precisely one of the major objectives attainable only through the formation of such a regional Reserve Fund. No indivi-

Table 4

Maximum Continuous Reserve Losses of ECAFE Countries, 1958-1967

	Period	Reserve Level at End of Preceding Year	Maximum Reserve Loss	
		($ millions)	($ millions)	(% of Reserves)
I. Developed ECAFE	1965	4091	311	8%
	1967	3593	189	5%
New Zealand	1960-61	217	80	37%
	1965-66	166	71	43%
Australia	1960	1249	360	29%
	1965	1906	375	20%
Japan	1961	1949	283	14%
II. Developing ECAFE	1961-62	3274	280	9%
	1964	3331	62	2%
India	1960-62	814	302	37%
	1964	607	109	18%
Pakistan	1961	317	40	13%
	1963-67	308	147	48%
China (Taiwan)	1962	136	22	17%
Vietnam	1961-62	216	63	29%
Philippines	1961	127	73	57%
Iran	1959-60	254	70	28%
	1964	246	47	19%
Indonesia	1961-63	351	(300)	(85%)
Ceylon	1959-64	176	125	71%
III. Total ECAFE	1961	6300	144	2%

Sources: Table 2 and International Financial Statistics.

Note: Includes only major countries and significant reserve losses.

dual central bank could afford to reduce that drastically its own foreign reserves, since future deficits might always absorb a much larger proportion of its outstanding reserves, as shown in Table 4. This Table summarizes the maximum continuous loss of gross reserves experienced by individual ECAFE countries over a period of one, or several years, in the decade 1958-1967. It can be seen that individual countries often experienced reserve losses of 10, 20 percent, or more, up to 57 percent in the case of the Philippines, 71 percent for Ceylon, and 85 percent for Indonesia, as compared with the single reserve loss of 2.3 percent for the ECAFE group as a whole in 1961.

It is indeed obvious that the need to hold external reserves, i.e. in the form of credits to other countries, varies in inverse relation to the economic size of the reserve holder's economic area, since intra-area transactions do not require extra-area currencies for their settlement. Thailand now needs dollars or sterling or gold to settle its transactions with any foreign country, inside as well as outside Asia. It could not count on being able to settle such transactions in bahts. They could perfectly be settled, however, within the area itself, through transfers of adequately guaranteed deposits with a common Reserve Fund such as proposed above. Reserves in non-area currencies would remain necessary to settle net deficits of the region as a whole with countries outside the region, but not to effect settlements within the area itself.

Taking account of traditional bureaucratic resistance to any new and untried change in existing institutions and operational habits, I suggested that the scheme be initiated on an extremely modest and conservative basis until all members had acquired sufficient familiarity with its advantages and safeguards to enlarge progressively its scope of operations, in the light of experience.

Agreed reserve deposits of a mere 10 percent of each member's gross reserves would endow an ECAFE Reserve Fund with more than $800 million of resources at the start. In order to safeguard beyond any question the full usability of members' deposits for deficit settlements--in the same proportion--outside as well as within the region, I proposed that the Fund be enjoined from expanding its loans and investments within the region whenever its external assets fall below 50 percent of its deposit obligations. Such a rule would enable the Fund to meet withdrawals from these deposits, in foreign as well as in member currencies, as long as the international reserves of the group as a whole do not decline by more than 50 percent (as against the maximum decline of 2.3 percent experienced over the last ten years). Such a reserve contraction for as large a group of countries would be without precedent in world history and would, if it could be imagined, entail of course a total collapse of the world monetary system, and particularly of the reserve currencies which were its pillars yesterday as well as of the currencies of the region itself. Alternative reserve investments in the traditional reserve currencies would not, in such a case, afford any more security than intraregional investments.

One would have expected that the main objections against such conservative proposals would come from prospective borrowers, disappointed at the limits imposed upon their access to the Fund's credits. I would have agreed with them that far bolder and more expansionist rules might be advisable in theory. They would be self-defeating, however, if they deterred prospective creditors from joining the agreement. The participation of prospective lenders is, of course, crucial to enable the Fund to meet the needs of prospective borrowers. Niggardly as they might be deemed at the start, the borrowing facilities of the system would, in any case, be better than nothing, and they could be expanded later when sufficient experience and familiarity with the system persuaded creditors of the possibility to exploit more fully its potentialities without exposing it to any real dangers of insolvency or illiquidity.

Paradoxically, the main objections raised so far have come not from prospective debtors, but from prospective creditors.

The first of these objections is that the claims accumulated on the Reserve Fund would constitute an additional credit burden for these countries, and that whatever loans they might be willing to extend might better be granted and negotiated bilaterally, in order to maximize the political and economic advantages of such lending. Such an objection clearly reflects a total misunderstanding of the proposals. First of all, any accumulation of claims on the Fund would be linked to the overall balance-of-payments of the countries concerned, i.e. to their actual reserve increases. They would not constitute additional lending, but merely rechannel differently the foreign lending--primarily to London and New York today--inevitably entailed in the accumulation of external reserves, in any form whatsoever.[8] Secondly, any direct bilateral lending would in fact decrease by an equivalent amount the accumulation of reserves and, therefore, the lenders' commitments to increase proportionately their deposits with the Fund. Fund deposits, moreover, would confer to the depositors a voice in their management which they do not have, of course, in the management of the reserves alternatively kept today with New York or London banks, or in U.S. or U.K. Treasury obligations.

The second, and somewhat more valid, objection is that any switch of reserves from London and New York to deposits in the Fund, might reduce the depositing country's access to London and New York credits. This would be made up, in part, by the direct access of members to the Fund credits themselves and by the greater bargaining power which the Fund would enjoy through the reinvestment of half, at least, of its deposits in foreign monetary and financial centers. What remains true is that this institutional shift might affect differently the distribution of such credits among members, presumably to the benefit of the deficit, rather than the surplus, countries.

On the other hand, the mechanism which is proposed here should also lead to a strengthening of confidence by foreign investors in the financial stability and economic development of the member countries in general. This should increase in time the overall inflow of foreign funds into the region, and benefit its stronger, as well as its weaker, members. This should offset, and indeed far more than offset, the implications of a moderate decline (50 percent, at most, of the 10 percent of reserves to be held in Fund deposits, i.e. 5 percent) in the reserves now held in foreign financial centers.

Let us now turn to these broader financial and economic opportunities which the proposed system would offer to the countries of the

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8 Even gold accumulation--relatively insignificant for the countries of the region, and probably less and less available as a form of reserve increases in the future--should be economically interpreted as a form of lending to the gold producers, secured by gold collateral. Any form of reserve accumulation entails an <u>immediate</u> transfer of real resources from the reserve holders to the reserve debtors or to the gold sellers, in exchange for reserve claims usable only for deficit financing <u>in the future</u>.

region.

IV. Potential Use of Fund Lending for Monetary Stabilization, Trade Expansion and Economic Development in the ECAFE Region

The participating countries should, in due time, decide for themselves how the resources contributed to a regional Reserve Fund should best be used in the collective interests of all, and every one, of the participating countries. They deprive themselves now of any such possibility, insofar as they abandon fully to foreign banks or Treasuries all management decisions regarding the use of the reserves held by them in foreign money markets.

Rational management decisions should, when sufficient experience has been gained, encompass a wide variety of objectives, ranging from trade promotion to monetary stabilization and even the financing of promising development projects. Initially, however, maximum safety and liquidity considerations will probably confine the Fund's lending operations to short-term or medium-term investments, closely linked with trade liberalization and monetary stabilization objectives.

My proposals to ECAFE are confined, for that reason, to the financing of one half, at most, of the participating countries <u>overall</u> deficits and reserve losses, and envisage repayment obligations extending, at most, over a five-year period. Past experience, however, suggests that the overwhelming bulk of Fund loans could be amortized far more rapidly and painlessly from the subsequent surpluses of the borrowing countries. If the system had been put into operation in 1958, \$839 million of the \$1095 million credits granted by the Fund over the years 1959-1966 would have been amortized, leaving only \$256 million of gross credits outstanding (see p. 179 of the ECAFE <u>Report</u>). The bulk of these credits, moreover, would have been covered, and indeed far more than covered, by the agreed deposits of the borrowers with the system. Only three countries would have been in <u>net</u> debt to the Fund: Pakistan (\$24 million), New Zealand (\$10 million) and Ceylon (\$4 million) for a total amount of \$58 million, or little more than 7 percent of the Fund's gross assets and deposit obligations (see text on p. 153, and Tables 12 and 13 on pp. 180-182 of the same <u>Report</u>.)

All these operations, by the way, would have arisen from <u>automatic</u> borrowing rights, rather than from <u>discretionary</u> lending requiring difficult and unfamiliar negotiating and/or management decisions. Their modest scope and medium-term maturities should make such automatism acceptable at the start, to take into account the difficulties of organizing such negotiating and management techniques among countries largely unfamiliar with them, little prepared to understand each other's problems, and even less to trust each other's policies.

In the longer run, however, the hoped-for expansion of the system should, in my opinion, be based primarily on discretionary rather than automatic borrowings. Whenever such expansion can be agreed on, in the light of experience, the process of negotiation itself will inevitably determine, however, the relative shares to be assigned to discretionary and to automatic credit lines.

The main objection raised against this proposed use of the Fund's resources is that credits related to the overall reserve position and balance-of-payments of members with the world at large--rather than with their intraregional surpluses and deficits--would do nothing to promote preferential--i.e. discriminatory--trading arrangements within the region itself. This is perfectly true, and explains the support expressed for such proposals by the IMF representative at the ECAFE meeting which debated them (see pp. 188-191 of the Report), in sharp contrast with previous IMF opposition to discriminatory payments arrangements, in Latin America for instance. The credits of the proposed Reserve Center would support--rather than conflict with--the multilateral and non-discriminatory stabilization objectives so often affirmed by the IMF and its members.

This is also the reason why prospective creditors could accept participation in such a system without running the risk of seeing their reserve deposits frozen into regional credits and unavailable for balance-of-settlements outside the region itself.

This does not mean, however, that mutual trade within the region would not benefit from such financial arrangements. On the contrary, trade liberalization commitments--whether preferential or not--would undoubtedly prove impossible to negotiate, and even more to implement, if countries experiencing temporary deficits could not count on some assistance from the countries in surplus, so as to enable them to honor their commitments and eschew a relapse into the trade and exchange restrictions which they would be required to renounce.

Mutual trade commitments would, of course, expand by exactly the same amounts the exports and imports of member countries as a group, and leave unaffected the net sum of their balance-of-payments surpluses and deficits. The impact of liberalization upon any one country's balance-of-payments, however, would be largely unpredictable, even though the resulting deterioration in some of the countries' balance-of-payments and reserve position would be exactly matched by the improvement in the balance-of-payments and reserve position of others.

The reserve mechanism proposed above should make acceptable to all members the acceptance of such risks, as it did in OEEC and EPU nearly twenty years ago, and in Central America ten years ago. The countries in surplus would extend temporary assistance to the countries in deficit, by diverting a minor portion of their actual reserve increases from foreign to regional investments, under conditions endowing such regional investments with profitability, liquidity and safety guarantees superior to those available today on their reserve investments in foreign monetary centers.

The preceding Sections of this paper have made clear the reasons why such a reform of the present reserve system of the ECAFE countries would be desirable in and by itself, irrespective of its link with parallel commitments regarding intraregional trade liberalization. There is no doubt, however, that the successful negotiation of such trade commitments would constitute an additional and major spur to the negotiation of an ECAFE reserve system.

Rationally, the latter could proceed without waiting for the former, while the former would be bound to fail, if not accompanied or preceded by the latter. The final success of an ECAFE trading negotiation raises, however, a host of other and difficult problems which are beyond the scope of this paper.

In any case, both of these proposed negotiations will be slow at best. The exact purposes and mechanisms of an ECAFE monetary arrangement are still only dimly understood by most policy-makers and even by official experts. Every effort should be made to accelerate the exploration and understanding of these proposals, and of possible alternative arrangments, even though their fianl implementation may be further delayed by political and other obstacles to an actual agreement.

Finally, and regretfully, it is possible, or even probable, that some countries may hesitate longer than others to accept full participation in such a system. I do not think that the countries which are ready to move should resign themselves to wait until even the most laggard have been convinced. Even subregional arrangements should prove beneficial, as long as they enlist the participation of prospective lenders as well as of prospective borrowers.

The EEC proceeded in this fashion, twelve years ago, and refused to be blocked by the refusal of Britain to join in their enterprise. The EEC countries have had no reason since then to deplore their haste, but Britain has certainly shown its regrets at having "missed the boat," and its determination to jump into it, or even to swim toward it, whenever it is allowed to do so. I hope, and trust, that this lesson will be pondered by all prospective members of ECAFE trade and payments arrangements. The main danger against which bureaucrats, and even statesmen, should be on guard has always been to do "too little and too late" rather than "too much and too soon!"

Statistical Appendix on the Evolution of the International Reserve System

Table 1

Sources of Reserve Creation: 1937-June 1968
(Annual rates, in billions of U.S. dollars)

	1938-49	1950-59	1960-64	1965-Mar. 1968	Apr.-June 1968
I. Gross Reserves	1.5	1.2	2.3	1.2	1.9
A. Monetary Gold	0.8	0.5	0.6	-0.8	1.1
1. Production	1.0	0.9	1.3	1.4	1.5
2. Private Absorption (-)	-0.1	-0.5	-1.1	-2.4	-0.4
3. Net Soviet Sales	-	-0.1	0.3	0.1	
B. Credit Reserves	0.7	0.7	1.7	2.0	0.9
1. Reserve Currencies	0.7	0.6	1.5	1.6	-4.7
2. IMF Lending	-	0.1	0.3	0.4	5.7
3. Minus IMF Surplus & EPU, EF & BIS Gold	-	-	-0.1	-	-0.1
II. Net Reserves (IA+IB3)	0.8	0.5	0.5	-0.8	1.0
A. Reserve Centers	0.2	-1.0	-2.7	-2.6	-0.5
1. United States	0.9	-1.2	-2.1	-1.4	6.7
2. United Kingdom	-0.6	0.1	-0.4	-0.5	-1.9
3. Euro-Currencies and other	-	0.1	-0.2	-0.7	-5.2
B. Other Countries	0.6	1.5	3.2	1.8	1.5
1. Gold	-0.1	0.8	1.5	0.7	3.2
Developed Counts.	-0.2	0.8	1.5	0.6	2.5
LDC's	0.1	-	-	0.1	0.7
2. Credit to:	0.6	0.7	1.8	1.0	-1.8
a/ Reserve Centers, by:	0.6	0.6	1.4	0.6	-3.6
Developed Counts.	0.2	0.5	1.4	-0.3	-3.4
LDC's	0.4	0.1	-	0.9	-0.2
b/ IMF, by:	-	0.1	0.3	0.4	1.8
Developed Counts.	-	0.1	0.4	0.4	1.9
LDC's	-	-	-0.1	-	-0.1
Annual Growth Rate of					
Gross Reserves	4.2	2.3	3.7	1.8	2.7
Net Reserves	2.7	1.4	1.2	-2.0	2.5
Net Reserves of Countries other than Reserve Centers	4.2	6.4	8.4	3.6	2.7

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Table 2

Sources of Reserve Creation: 1938-June 1968
(in %)

	Before 1938	1938-49	1950-59	1969-64	1965 March 1968	Apr-June 1968
I. In % of Gross Reserves Changes	100	100	100	100	100	100
A. Monetary Gold	91	54	44	25	-71	55
1. Production	143	64	79	57	119	75
2. Private Absorption (-)	-53	-9	-46	-47	-199	-20
3. Net Soviet Sales	1	-1	11	15	8	
B. Credit Reserves	9	46	56	75	171	45
1. Reserves Currencies	9	45	49	66	137	-243
2. IMF Lending	x	1	6	12	33	294
3. Minus IMF Surplus and EPU EF and BIS Gold	-	-	1	-2	1	4
II. In % of Changes in Net Reserves of Countries other than Reserve Centers:						
World Net Reserves	236	140	35	16	-48	68
A. Reserve Centers	136	40	-65	-84	-148	-32
1. United States	115	152	-79	-66	-79	458
2. United Kingdom	22	-104	9	-11	-29	-135
3. Euro-Currencies and Other	-2	-7	6	-6	-40	-355
B. Other Countries	100	100	100	100	100	100
1. Gold	78	-11	55	46	42	225
Developed Countries	67	-34	55	47	35	174
LDC's		24	-	-1	7	51
2. Credit to:	22	111	45	54	58	-125
a/ Reserve Centers, by:	22	110	40	44	34	-248
Developed Countries	18	38	33	42	-15	-235
LDC's	4	72	8	1	50	-12
b/ IMF, by:	x	1	5	10	24	123
Developed Countries	x	1	6	12	24	130
LDC's	x	-	-1	-2	-	-7

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Table A

Integration of Reserve Statistics: 1937-June 1968
(in millions of U.S. dollars)

	1937	1949	1959	1964	1965	1966	1967	March 1968	June 1968
I. Gross Reserves	27656	45518	57345	68670	70430	71870	73522	72578	73065
A. Gold	25290	34975	40207	43012	43230	43179	41605	40238	40506
1. IMF & BIS	4	1505	2312	2172	1375	2279	2100	2408	1901
2. Countries	25286	33470	37895	40840	41855	40900	39505	37830	38605
a/ Reserve Centers	16931	25884	22021	17607	16330	15175	13356	12196	12155
b/ Other Counts.	8355	7586	15874	23233	25525	25725	26149	25634	26450
LDC	1198	2845	2905	2715	2705	2555	2895	3110	3295
Developed	7157	4741	12969	20518	22820	23170	23254	22524	23155
B. Credit Reserves	2366	10543	17138	25658	27200	28691	31917	32340	32559
1. Reserve Currencies	2370	10390	16200	23675	23200	24640	28270	29030	27845
a/ Reserve Center	-	431	222	611	1520	2480	3749	3975	3689
b/ Other Counts.	2370	9959	15978	23064	21680	22160	24521	25055	24156
LDC	385	5370	6500	6745	7965	8600	9070	9610	9565
Developed	1985	4589	9478	16319	13715	13560	15451	15445	14591
2. IMF Lending to	×	204	909	2236	3824	4075	3560	3527	4951
a/ Reserve Center	×	58	500	1316	2707	2920	2091	2109	3507
b/ Other Counts.	×	146	409	920	1117	1155	1469	1418	1444
LDC	×	73	68	834	980	1027	1151	1106	1200
Developed	×	73	341	86	137	128	318	312	244
3. Other: IMF Surplus & EPU, EF & BIS gold	-4	-51	29	-253	176	-24	88	-217	-237
II. Net Reserves (IA+IB3)	25286	34924	40236	42759	43406	43156	41691	40021	40269
A. Reserve Centers	14561	17328	7605	-6004	-7453	-9579	-12836	-14490	-14605
1. United States	12360	22828	10884	101	-1199	-1094	-4521	-4415	-2751
a/ Gold	12790	24563	19507	15471	14065	13235	12065	10703	10681
b/ Credit	430	-1735	-8623	-15370	-15264	-14329	-16586	-15118	-13432
(i) Currencies	430	-3196	-10120	-15339	-15068	-13644	-15973	-14554	-13305
(ii) to IMF	×	1461	1497	-31	-196	-685	-613	-564	-127
2. United Kingdom	2441	-4746	-3424	-5266	-5648	-6311	-5849	-6932	-7423
a/ Gold	4141	1321	2514	2136	2265	1940	1291	1493	1474
b/ Credit	1700	-6067	-5938	-7402	-7913	-8251	-7140	-8425	-8897
(i) Currencies	1700	-6009	-6003	-6886	-6006	-6342	-6082	-7358	-6420
(ii) to IMF	×	-58	65	-516	-1907	-1909	-1058	-1067	-2477
3. Euro-Currencies, etc.	-240	-754	145	-839	-606	-2174	-2466	-3143	-4431
B. Other Countries	10725	17596	32631	48763	50859	52735	54527	54511	54874
1. Gold	8355	7586	15874	23233	25525	25725	26149	25634	26450
2. Credit to:	2370	10010	16757	25530	25334	27010	28378	28877	28424
a/ Reserve Cent.	2370	9959	15978	23064	21680	22160	24521	25055	24156
b/ IMF	×	51	779	2466	3654	4850	3857	3822	4268

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Table B

Sources of Reserve Creation: 1938-June 1968
(in millions of U.S. dollars)

	Before 1938	1938-49	1950-59	1960-64	1965 March 1968	Apr. June 1968
I. Gross Reserves:	27656	17862	11827	11325	3908	487
A. Monetary Gold	25290	9685	5232	2805	-2774	268
1. Production	39590	11465	9390	6455	4655	365
2. Private Absorption (-)	-14630	-1640	-5423	-5365	-7759	-97
3. Net Soviet Sales	330	-140	1265	1715	330	
B. Credit Reserves	2366	8177	6595	8520	6682	219
1. Reserves Currencies	2370	8020	5810	7475	5355	-1185
2. IMF Lening	×	204	705	1327	1291	1424
3. Minus IMF Surplus and EPU, EF & BIS gold	-4	-47	80	-282	36	-20
II. Net Reserves (IA+IB3)	25286	9638	5312	2523	-2737	248
A. Reserve Centers	14561	2767	-9723	-13609	-8486	-115
1. United States	12360	10468	-11944	-10783	-4516	1664
2. United Kingdom	2441	-7187	1322	-1842	-1666	-491
3. Euro-Currencies & other	-240	-514	899	-984	-2304	-1288
B. Other Countries	10725	6871	15035	16132	5749	363
1. Gold	8355	-769	8288	7359	2401	816
Developed Countries	7157	-2416	8228	7549	2006	631
LDC's	1198	1647	60	-190	395	185
2. Credit to:	2370	7640	6747	8773	3348	-453
a/ Reserve Centers, by	2370	7589	6019	7086	1991	-899
Developed Countries	1985	2604	4889	6841	-874	-854
LDC's	385	4985	1130	245	2865	-45
b/ IMF, by	×	51	728	1687	1357	446
Developed Countries	×	62	923	2045	1368	472
LDC's	×	-11	-195	-358	-11	-25

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Sources, Method of Presentation and Brief Comments

Sources: These tables are uniformly and exclusively based on the most recent statistics published in the International Financial Statistics (October 1968 and annual Supplements) Tables on "International Reserves" and on "Members' Fund Positions" (pp. 14-18 and 4-5 of the October 1968 issue, for instance), with three exceptions:

1. IFS gold estimates had to be supplemented, for the pre-1959 period, by other sources (particularly from the Bank for International Settlements) listed on p. 80 of my Princeton study on The Evolution of the International Monetary System: Historical Reappraisal and Future Perspectives (Princeton, 1964).

2. The systematic integration of these reserve estimates brought to light some minor misprints in the IFS totals (in 1959 and June 1968, for instance).

3. The IFS rounding-up of group estimates to the next $5 million introduces other apparent discrepancies in some totals. I have avoided such rounding-up wherever feasible, in order not to introduce further, but avoidable, rounding-up errors in my estimates of period changes, annual growth rates and percentage distribution of such changes.

Tables B, 1 and 2 are all derived from the basic estimates of Table A, given in millions of dollars. Tables 1 and 2, however, recast these estimates in simplified and more readable form, and Table 1 in billions of dollars with one decimal--rather than in $ millions--as befits the probable order of magnitude of unavoidable errors and omissions in such estimates (or "guesstimates").

Method of Presentation of Tables 1 and 2:

1. I attach particular value to grouping such estimates in a way that stresses their integration and internal consistency and helps spot occasional errors--such as mentioned above--and puzzling movements in some residual estimates--such as those in line II A 3 of Table 1, which are, however, largely explainable by the misleading method of reporting of U.S. liabilities arising from central banks' investments in the Euro-dollar market.

Note that the discrepancy between monetary gold (line I A) and net reserves (line II) is due to the accounting of the IMF undistributed Surplus and of EPU, EF and BIS gold (line I B 3).

2. The choice of chronological periods grouping together cumbersome yearly estimates is determined--with some unavoidable arbitrariness--by an attempt to bring out some major changes of trend, such as:

a/ the "dollar shortage" of 1937-49 and the subsequent "dollar glut";
b/ the accentuation of the "dollar glut" after 1959;
c/ the aggravation of the gold shortage and tapering off of dollar-reserves accumulation by developed countries after 1964;
d/ the suspension of gold pool operations in March 1968, and the huge IMF financing of foreign-exchange reserves liquidation in the following quarter.

3. Changes in Gross Reserves (line I) are broken down by IFS (bottom of p. 16 of October 68 issue, for instance) in accordance with the "composition" of countries' reserves between gold, reserve positions in the Fund, and foreign exchange. My tables emphasize instead the sources of reserve growth, i.e. world monetary gold (I A)--rather than countries' gold--and credit reserves, (I B) broken down themselves between reserve currencies (I B 1) (i.e. direct credit to reserve centers), IMF lending (I B 2) (i.e. loans, and gold deposits and investments)--rather than reserve positions in the Fund, a portion of which represents a transfer of gold by members to the Fund--and the minor adjustments (I B 3) mentioned under (1) above (last paragraph).

4. Changes in Net Reserves (II = I A + I B 3) are broken down, by ownership, between reserve centers (II A) and other countries (II B), and the reserve changes of these subdivided between changes in gold reserves (II B 1) and in credit reserves (II B 2). The different--and changing--propensities of developed and less developed countries respecting gold and foreign exchange assets are brought out in the further subdivision of these items.

Brief Comments

1. The last three lines of Table 1 highlight the sharp decline of net reserves growth over this period, partly masked for gross reserves by the growth of credit reserves, i.e. reserve claims on the reserve centers and the IMF. The last line, however, shows that the reserves of countries other than reserve centers grew at an increasing pace through 1964, but at a sharply declining one afterwards. A further regional breakdown would highlight even more dramatically the reasons why continental Europe--and particularly the EEC countries--considered their own reserve growth as excessive and contributing to inflationary pressures, while other countries complained more and more of the growing shortage of world liquidity.

2. The drying-up of gold as a major source of reserve creation is best seen on Line I A of Table 2. Its contribution practially ceased in 1964 and became, of course, highly negative between September 1967 and the suspension of gold pool operations on March 17, 1968. Line I A 3 also shows the growing dependence of declining monetary gold accretions on net Soviet sales (up to two-thirds in 1960-64) and the sharp decline of such sales afterwards.

3. The expansion of credit reserves (line I B) compensated, or more than compensated, this drying-up of gold as a source of reserve creation. This expansion centered first on the accumulation of reserve currencies (more and more, however, through negotiated and exchange-guaranteed rescue operations in favor of sterling, swaps, Roosa bonds, etc., rather than traditional and unguaranteed dollar and sterling balances). The breakdown of line II B 2 a shows, however, that in spite of such negotiated transactions, the developed countries began in 1965 to reduce, rather than increase further, their foreign exchange holdings, and that even the LDC's began to follow the same course after March 1968. A further breakdown of these estimates by years and by countries would show that liquidation of foreign exchange balances by developed countries was particularly massive in 1965 and by no means confined to Gaullist France. (A breakdown between sterling and dollar balances and between "negotiated" and "traditional" accumulation would also be interesting.)

Line B 2 (particularly of Table 2) shows a rapid increase of IMF lending as a source of reserve creation, and a dramatic increase in such operations in the second quarter of 1968 to compensate for --and permit--the liquidation of dollar and sterling balances. (Apparent changes in sterling balances after September 1967, however, should be corrected for the impact of devaluation losses upon their dollar valuation).

4. Line II A of Table 2 shows the growing dependence of "other countries" reserve increases upon the reserve losses of the reserve centers, rather upon increases in net world reserves. This so-called "cannibalizing" process could not, of course, continue indefinitely.

Line II A 3 shows a spectacular increase in the discrepancy between the reserve liabilities reported by the U.S. and the U.K. and the reserve currency assets reported by other countries. This discrepancy is, of course, explainable in part by the accumulation of reserve currencies other than dollars and pounds,--wrongly grouped here with U.S. and U.K. liabilities--but most of the recent and exceedingly large changes in this item are clearly related to central banks' investments in the Euro-dollar market ($3.1 billion at the end of 1967) and to discrepancies in the reporting of dollar and sterling assets and liabilities resulting from so-called "swap" operations.

5. Lines II B 1 and 2 show, in the last two columns, increasing switches from reserve currencies to gold and IMF assets, even by the LDC's.

Further analysis of lines II A 1 and 2 of Table A estimates, supplemented by further chronological breakdowns between years and quarters, would also show how such switches can interfere with a smooth functioning of the adjustment mechanism from the reserve center countries: relieving pressures for correction of their deficits for considerable periods, but aggravating them to crisis proportions in others (see my article on "The Co-existence of Three Types of Reserve Assets," in the June 1967 Banco Nazionale del Lavoro Quarterly Review, pp. 114-121 and 128-129).

6. The trends and gyrations briefly summarized above highlight some of the basic wheaknesses and sources of instability and ultimate unviability of the past and present system of reserve creation. The SDR agreement opens the door to a more raticnal adjustment of overall reserves to legitimate needs, in future years. Much remains to be done, however, to improve the working of the adjustment mechanism--particularly for the reserve center countries--and reduce de-stabilizing switches between the different types of reserve assets.

Table 3

"Traditional" and "Negotiated" Reserve Holdings: 1963-June 1968
(in billions of U.S. dollars)

	End 1963	1964-June 1968	Changes 1964	1965	1966	Jan.-Sept. 1967	Oct. 1967 Mar. 1968	Apr. June 1968
I. Non-Soviet World	66.4	6.7	2.3	1.8	1.4	0.6	0.1	0.5
A. Traditional	61.8	-2.8	1.5	0.4	-1.4	-0.4	-2.5	-0.3
1. Gold	40.2	-1.6	0.6	1.0	-1.0	-0.3	-2.8	0.8
2. Fore. Exchange	21.6	-1.2	0.9	-0.6	-0.5	-0.2	0.3	-1.1
a) Sterling	6.5	-2.4	-0.1	-0.5	-0.2	-0.2	-0.8	-0.6
b) Dollars	14.0	-2.2	1.2	0.1	-1.9	0.5	-0.3	-1.8
c) Unrecorded	1.1	3.4	-0.2	-0.2	1.6	-0.4	1.4	1.3
B. Negotiated	4.6	9.5	0.8	1.4	2.8	1.0	2.6	0.8
1. Fore. Exchange	0.6	6.8	0.6	0.2	1.9	1.5	2.8	-0.1
a) Sterling	-	3.5	0.6	0.2	0.9	0.2	1.9	-0.4
b) Dollars	0.6	3.4	-	-	1.0	1.3	0.9	0.2
2. Reserves in IMF	3.9	2.7	0.2	1.2	1.0	-0.4	-0.2	0.9
II. North Atlantic Area	52.0	2.7	2.1	0.9	0.6	0.1	-1.0	-
A. Traditional	48.0	-6.1	1.4	-0.4	-2.0	-0.9	-3.6	-0.6
1. Gold	36.3	-2.6	0.7	1.1	-1.0	-0.2	-3.5	0.3
2. Fore. Exchange	11.7	-3.5	0.7	-1.5	-1.0	-0.7	-0.1	-0.9
a) Sterling	1.0	-0.4	-	-0.1	-	-0.1	-0.1	-0.1
b) Dollars	9.9	-2.5	0.6	-0.5	-1.6	0.7	-0.1	-1.6
c) Unrecorded	0.8	-0.6	-	-0.9	0.6	-1.3	0.1	0.8
B. Negotiated	4.0	8.8	0.8	1.3	2.6	1.0	2.6	0.5
1. Fore. Exchange	0.6	6.8	0.6	0.2	1.9	1.5	2.8	-0.1
a) Sterling	-	3.5	0.6	0.2	0.9	0.2	1.9	-0.4
b) Dollars	0.6	3.4	-	-	1.0	1.3	0.9	0.2
2. Reserves in IMF	3.4	2.0	0.1	1.1	0.7	-0.4	-0.2	0.7
III. Rest of World	14.4	4.0	0.2	0.8	0.9	0.5	1.1	0.5
A. Traditional	13.8	3.3	0.1	0.8	0.6	0.5	1.1	0.3
1. Gold	3.9	1.0	-0.1	-0.1	0.1	-0.1	0.7	0.5
2. Fore. Exchange	9.9	2.3	0.1	0.9	0.4	0.5	0.3	-0.2
a) Sterling	5.5	-1.9	-0.1	-0.4	-0.2	-0.1	-0.6	-0.5
b) Dollars	4.1	0.3	0.5	0.6	-0.3	-0.2	-0.2	-0.2
c) Unrecorded	0.3	4.0	-0.2	0.6	1.0	0.8	1.2	0.5
B. Negotiated	0.6	0.7	0.1	0.1	0.3	-	-	0.2
1. Fore. Exchange	-	-	-	-	-	-	-	-
2. Reserves in IMF	0.6	0.7	0.1	0.1	0.3	-	-	0.2

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November 1968

Note on Table 3

"Traditional" and "Negotiated" Reserve Holdings

This Table is designed to illustrate and quantify--as far as feasible on the basis of inadequate reporting--the evolution of the international monetary system from the former so-called "gold-exchange standard" toward a "negotiated credit-reserve standard."

The traditional sources of reserve creation of the gold-exchange standard were:

1. gold

2. spontaneous holdings of gold-convertible foreign exchange.

Both of these sources have not only dried up in recent years; they are, in fact, contracting at an accelarated pace, expecially among the largest reserve holders of the North Atlantic Area. This group of countries shows (lines II A 1 and 2) a total contraction of $6.1 billion in such reserve assets over the period 1964-June 1968: $2.6 billion for gold and $3.5 billion for traditional forms of foreign-exchange reserves.

The relatively modest increase in the gross reserves of this area (line II) is more than accounted for by the increase in "negotiated" reserve holdings ($8.8 billion, on line II B), of which $6.8 billion in negotiated foreign-exchange holdings (line II B 1) and $2.0 billion in reserve positions in the Fund.

"Traditional" forms of reserve holdings still dominate the substantially larger reserve increases ($4.0 billion) of other countries (primarily the less developed countries.) One should note, however, the declining role of foreign-exchange reserves in these increases since the end of September 1967 ($240 million at an annual rate, as against $740 million a year, on the average, in the period 1963-September 1967) and the sharp increase in their accumulation of gold reserves (more than $1,600 million at an annual rate, as against minus $10 million a year in the previous period).

Sources and Notes:

1. Basic estimates are uniformly derived from the October 1968 issues of International Financial Statistics ("International Reserves" Tables and items 4 of the United Kingdom pages) and the Federal Reserve Bulletin (Table 7).

2. The calculation of "negotiated" reserves in the IMF does not, of course, raise any difficulty, but "negotiated" foreign-exchange reserves can only be approximated. I have classified as negotiated:

a/ dollar reserves: the sum of outstanding U.S. swap commitments (calculated from Table 2, p. 1520 of the September 1967 Federal Reserve Bulletin, and later semestical reports of Charles A. Coombs on "Treasury and Federal Reserve Foreign Exchange Operations"; unreported estimates for the end of September 1967 and March 1968 are entered as the reported estimate for September 1, 1967 and average of reported estimates for March 8 and April 26, 1968) and of "illiquid" U.S. liabilities to central banks and governments (Roosa bonds, etc., entered here as the excess of the U.S. liabilities reported at the bottom of the "Foreign Exchange" Table of IFS over the "liquid" liabilities to foreign official institutions reported in the first column of Table 7 of the Federal Reserve Bulletin).

b/ sterling reserves: none through 1963; and, afterwards, all external sterling liabilities to central monetary institutions of non-sterling area countries of North America and Western Europe, as reported on lines 4 a a and 4 a b of the United Kingdom page of IFS, plus $202 million of foreign currency deposits at the end of 1964 and $39 million at the end of 1966 (= excess of estimated U.K. liabilities reported at the bottom of the Foreign Exchange Table of IFS over line 4 a of the United Kingdom page), minus $600 million in 1964, $500 million in 1965, $400 million in 1966, and $300 million afterwards. The rationale for this admittedly rough assumption is derived from the fact that "central bank assistance" to the United Kingdom was negotiated repeatedly, beginning in 1964, only with non-sterling area countries of North America and Western Europe and that the excess of reported liabilities to the central monetary institutions of these countries over the "special assistance credits" from these countries--as reported in the Bank of England Quarterly Bulletin--was about $595 million in December 1964, $510 million in March 1965, $530 million in June 1965, and $490 million in September 1965. The amounts of "special central bank assistance" were no longer reported subsequently, but may be roughly approximated by assuming that "unnegotiated" sterling holdings of these countries continued to decline afterwards to, let us say, about $400 million by the end of 1966 and $300 million by the latter part of 1967. The error of this estimate can hardly exceed $200 or $300 million out of the $6500 million to $8500 million of official sterling liabilities reported over the period 1963-June 1968.

3. The remainder of dollar, sterling and unallocated ("difference" line of the Foreign Exchange Table of IFS) is classified as "traditional." It should be noted, however, that much of the sterling holdings of the sterling area was only influenced by formal, or informal, arrangements between the United Kingdom and the holding countries.

4. All these forms of reserve holdings are then broken down regionally between the North Atlantic Area (i.e., the United States, Canada and Western Europe) and the Rest of the World (Japan, Australia, New Zealand, South Africa, and the less developed areas), on the basis of the breakdown available from IFS, the Federal Reserve Bulletin, and the Bank of England Quarterly Bulletin. It will be noted that "negotiated" dollar and sterling reserves, as defined above, involve only the foreign exchange holdings of the North Atlantic Area group of countries.

Note also that Iceland's and Ireland's foreign-exchange reserves are included in this group (as "traditional," unnegotiated holdings) and assumed to be held only in sterling, even though a few millions may be held in dollars or other currencies.

5. Part of the large decline in "traditional" sterling holdings expressed in dollars between September and December 1967 are due to the devaluation of sterling. This may be roughly estimated at about $800 million, by recalculating the September estimate on the basis of the new exchange rate ($2.40 per pound) or the December estimate on the basis of the previous exchange rate ($2.80 per pound).

6. A most puzzling fact revealed by these calculations is that the bulk of the large increase in the excess of reported reserve assets over the reported reserve liabilities of the United States and the United Kingdom ("difference" line of the Foreign Exchange Table of IFS) over the period 1966–June 1968 (from $606 million to $4431 million) appears in the "other" holdings of the "Rest of the World" (which rise from about $680 million to about $4,235 million) rather than in those of the North Atlantic countries (up from minus $75 million to plus $190 million).

This fits neither with the IFS comments (e.g. p. 105 of the October 1968 issue) on this discrepancy, which stress the impact of the liquidation of the U.K. portfolio of dollar securities and its inclusion in U.K. reserves ($885 million in 1966 and $490 million in the last quarter of 1967) and differences in the reporting of swap assets and liabilities, nor with the BIS estimate (p. 154 of 1968 Annual Report) of $3.1 billion of Euro-dollar investments by European official monetary institutions at the end of 1967 (holdings reported as liabilities to foreign commercial banks in U.S. statistics). All three of these possible sources of discrepancy should bear primarily on reserve estimates for the North Atlantic Area group rather than for the Rest of the World.

COMMENT ON ROBERT TRIFFIN'S PAPER BY HARRY G. JOHNSON

Robert Triffin introduces his comprehensive and very interesting paper with customary but unnecessary modesty. It has been evident in our discussions so far that many of the problems of trade and development, both in the Pacific region and in the North-South context as a whole, are rooted ultimately in the inadequacies of the present international monetary system and the policies of restrictionism that those inadequacies force on the members of the system, particularly the United States; and that the problems really cannot be satisfactorily solved until the international monetary system has been fundamentally reformed. Triffin was the first to call to academic and official attention the inherent inconsistencies of the gold exchange standard, and has kept up a running commentary on the logical development of successive crises. It is an extremely valuable contribution to our deliberations to have his views on the current crisis situation in international monetary affairs at our disposal.

Triffin's paper falls into two parts, a general analysis of the death of the gold exchange standard and of the parallel rise of regional economic operations, and discussion of a specific proposal for an ECAFE Reserve System. For convenience, I shall discuss these separately.

Triffin begins the general analysis by discerning two important world-wide trends, the accelerating disintegration of the gold exchange standard and the "rewarding" postwar development of close regional cooperation and in some cases integration. The use of the adjective "rewarding" and the presentation in general, suggest that in some broad way regional integration is a way out of international monetary difficulties. I should like to begin by remarking that, insofar as European economic integration is concerned, that trend has undeniably contributed to the exacerbation of the international monetary problem, the discrimination against U.S. trade inherent in it having been an important causal element in the worsening of the U.S. current and capital accounts. Our discussion yesterday showed that JANFTA would encounter U.S. opposition for essentially the same reasons.

With respect to the death of the gold exchange standard, I agree with most of what Triffin says, up to his criticisms of the S.D.R. scheme. I agree specifically that the establishment of the two-tier gold price system embodied a contradiction between the desire of some to retain gold and of others to demonetize it; and I would report that his minimal prediction that gold purchases would be resumed at the \$35.00 an ounce price has been confirmed by recent newspaper reports of an international agreement to that effect. I was particularly intrigued by his analysis of and statistical exercise on the change from voluntary to "negotiated" holdings of reserve currencies, which call attention to a rather neglected aspect of recent developments. I would myself fit the deaths of gold and of voluntary reserve currency holding into a broader theoretical framework, in which the gold standard brings about its own demise in consequence of the inherent inefficiency of a commodity money, the attractions of substituting interest-bearing paper money for gold, the effects of this substitution in permitting inflation and so gradually reducing the profitability of gold production and increasing private demands for gold, and the effects of increasing gold shortage in attenuating the voluntary acceptability of paper substitutes for gold. One way out, which Triffin and I both regard with horror but which I feel more strongly than he may be the ultimate last resort, is to increase the monetary price of gold; this might be done deliberately, or be the outcome of an experiment with floating exchange rates. The other alternative is to move to a regulated credit reserve standard; this is the purpose of the Special Drawing Rights scheme.

It is with respect to Triffin's criticisms of the SDR scheme that we part company, for I find these criticisms in general both unconvincing, and not logically pointing towards the reforms Triffin advocates in place of the SDR. First, Triffin makes great play with the notion of a "gift" to the rich, thus catering to the popular belief that in the creation of credit someone gets something for nothing. On the contrary, creation of credit by mutual agreement is an equal exchange of assets for liabilities; it is the insistence that the assets should be given to the poor that introduces a technically unnecessary and politically controversial element of international redistribution into what could be a purely financial arrangement. Second, Triffin adduces the principle of strengthening the adjustment mechanism and the concept of "blind underwriting of deficits" in his criticism; but any arbitrary rule for distributing new reserves, provided it is adhered to, leaves the need for adjustment policies intact except insofar as under the present system shortage of international liquidity manifests itself in pseudo-adjustment problems; Triffin's proposal to use the lending power of new credit reserves for financing various kinds of deficit will tend to weaken rather than strengthen the adjustment mechanism, and discipline over debtors; and the proposed "reserve settlement account" is concerned with solving the so-called "confidence problem" and contributes nothing whatsoever to strengthening the adjustment mechanism. I agree, however, that without a resolution of the status of gold and the reserve currencies, the need for SDR may fluctuate erratically; though it could be argued that international central bank collaboration could handle the problem if SDRs were once firmly established. My own criticisms of the SDR scheme are that the distribution of voting rights is likely to make the amount of SDRs provided too niggardly, and that the gold guarantee is likely to result in SDRs being frozen into central bank reserve asset portfolios so long as uncertainty remains about the future price of gold.

Turning to the trend towards regional cooperation, Triffin argues that a negotiated credit reserve system would impose severe burdens on IMF management, which would be relieved by the regional evolution of international monetary cooperation, since neighbors can exercise surveillance over each other more easily and effectively than can the nembers of a global arrangement. The Bonn crisis of November 1968 raises some awkward questions about this proposition. More generally, I found Triffin's argument in this section difficult to pin down; it seems to me that for the purpose of his ECAFE reserve system proposal he needs and wants to argue that monetary cooperation must precede trade liberalization, but is confronted by contrary facts of history, and has to resolve the issue dubious contention that the accident of dollar glut has enabled Europe to escape the laws of logical necessity. An alternative view is that monetary co-operation and particularly integration offers too little prospect of direct benefits to justify the sacrifice of sovereignty entailed in it.

I come now to the specific proposal for an ECAFE Reserve System. This is technically a complex subject, which I lack time to discuss in detail. I shall make only a few brief general remarks on it.

First, it is probably true that by pooling their reserves the countries of the region could raise earnings on their reserve assets, through lengthening the average maturity of the aggregate portfolio in response to the reduced risk of reserve loses. But Triffin adds to that argument the idea of gain from eliminating intermediation profits now enjoyed by New York and London. The belief that middleman's margins represent an uneconomic and avoidable waste is a fallacy more commonly encountered in relation to farming than to finance; they are, in fact, payments for services which are typically difficult to provide more cheaply by co-operative effort, as indeed, much of the history of consumers and producers cooperatives in poor countries tends to confirm. It may be that Triffin's new Asian bankers would be more efficient than New York and London bankers in financial intermediation to serve Asia's needs, but this needs to be demonstrated and not simply assumed.

Second, I am somewhat mystified by Triffin's discussion of the unit of account. He implies that somehow a unit of account can be found that will involve less exchange risk than sterling or dollars; but the examples of success he cites involve the use of the dollar as the unit of account, though not as the reserve asset itself.

Third, I find Triffin's rebuttals of the criticisms of the proposal well-argued, and convincingly in favor of at least starting an exploration of it. I am, however, somewhat skeptical about the desirability of moving very far from the initial automatic basis for borrowing towards a discretionary lending scheme. There is always, in relation to development, a strong temptation to believe in the catalytic value of some modest institutional change or financial manipulation, and faith in the power of monetary magic, on the one hand, and in the entrepreneurial powers of central bankers, on the other, is particularly hard to restrain within the bounds of common sense. This motif emerges indirectly, but nevertheless definitely, in Triffin's contention that regional trade liberalization, would be bound to fail if it were not preceded by negotiation of an ECAFE Reserve System. There is no evidence for this contention, as opposed to the contrary view that regional trade liberalization without regional monetary cooperation is perfectly possible provided that the international monetary system is functining well and countries are prepared to play the rules of the international monetary game. I suspect that Triffin is implicitly envisaging a continuing situation of international monetary crisis, which, as Sperry Lea has remarked, has already been turning commercial policy into a tool of balance-of-payments policy, and would indeed require regional trade cooperation to be backed up by regional monetary cooperation. But continuing crises apart, it seems to me that the case for an ECAFE reserve system should rest on its direct financial advantages in economizing on reserves and raising the yield on reserve assets, not on a presumed prerequisiteness to regional trade liberalization.

COMMENTS ON ROBERT TRIFFIN'S PAPER BY ARTHUR PAUL

In September, 1967, I had the privilege of being present when Professor Triffin presented his earlier paper on this subject at an ECAFE meeting in Bangkok. His present paper relates the proposals that he made at that time to today's global monetary problems and answers a number of the objections that have been made to the plan described in the earlier paper. When Professor Triffin first presented his plan to the representatives of most of the Asian countries, a number of those who were present felt that he was many years ahead of his time in making the proposals contained in the plan. Therefore, it is interesting to take a look at what has happened since then.

The decision made at the ECAFE meeting which first examined the plan was a sensible one. Most of the representatives and experts of the various countries present felt that the plan warranted consideration, and that, as a first step, ECAFE's staff should examine the benefits to the region of the establishment of a simple and voluntary clearing mechanism among those Asian countries that might wish to join it. This was not an unanimous decision. The Japanese group opposed the plan and the Thai representatives expressed strong reservations. But the group as a whole did request ECAFE to ask the IMF to make a survey of the existing clearing facilities in Asia and to comment on the possible benefits and the general desirability of the creation of supplementary and more direct clearing facilities. IMF has nearly completed its report on this matter, and it will be interesting to see what it discloses. In the meantime, the British exchange banks, which now provide many of the existing facilities, have been restricted in their operations by the monetary difficulties of the U.K. They are no longer permitted to use sterling to finance non-sterling area transactions, so that the clearing facilities in the region are today less satisfactory than they were a year ago.

The next steps taken by ECAFE as a result of further consideration of the Triffin plan were based on recommendations made at a meeting of ECAFE's Committee on Trade held in January, 1967. At that time a number of Asian delegates brought out the close relationship between trade liberalization measures and the proposals for payments arrangements. There was much discussion of which should come first: trade liberalization or payments plans. Again the approach adopted by ECAFE seems to be a sensible one. It is that plans for payments arrangements and trade liberalization measures should proceed simultaneously.

It is interesting that some member countries of ECAFE are now asking for the preparation of what might be called "a minimum set of standards for trade practice" which each country must adopt in order to qualify for membership in a clearing mechanism or some other form of trade payments arrangements. This is an important step in an important field. It has arisen out of the discussions of the Triffin proposals, and it is the subject of much current discussion and study throughout the area. Furthermore, for many Asian trade officials not familiar with monetary matters, the study of the Triffin Plan has been an educational experience which in itself is of importance.

At a recent gathering of the chief officials of a number of the Central Banks of Asia, the subject of payments arrangements was an important item on the agenda. They examined the Triffin plan, and it is reported that there was a considerable degree of support voiced in favor of it, or something like it, as an objective toward which to move.

Originally the countries that supported the plan were only those who were debtors in terms of trade balances with their neighbors; almost all of the creditor countries objected to the plan or were non-committal. This seems now to be changing. The new Triffin paper points out some very good reasons for this change in attitude and shows how it may be to the advantage of creditor countries to support the proposal.

Another event of interest is a formal decision on the part of the ASEAN countries to consider the establishment of some form of payments arrangements among themselves, without waiting for the entire region to act. These countries have authorized the making of a separate study for their area alone. This parallels the position recently taken by the ANDEAN group of Latin American countries.

It has been equally interesting to watch the changing attitudes of Japanese and American representatives at meetings at which these matters are discussed. Although some Japanese spokesmen have at times expressed mild interest, the official Japanese position has been definitely negative. The American position appears to have shifted from one of indifference to support expressed in very general terms and related to the U.S. policy of fostering regional co-operation.

From this brief description of events that have taken place since September 1967, it is clear that Professor Triffin's proposals have caused a good many things to happen. The Asian countries are still far from serious consideration of a plan for pooling a percentage of their reserves and making loans to each other to ease balance of payments difficulties; nevertheless, there have been some first steps taken, and there are plans for other steps to follow. It is too early to worry very much about the more sophisticated aspects of the plan and its relationship to global monetary problems. The first steps, especially those that call for trade liberalization, will become part of an evolving plan designed to help to make trade among neighboring countries somewhat easier to transact within the Asian region. Whether the plan takes the exact form proposed by Triffin, or some variation of it, is not too important today. The existence of the plan, alone, has been a useful stimulus that has helped the preliminary steps that ECAFE is taking in this field.

Chapter 10

THE ROLE OF THE ASIAN DEVELOPMENT BANK IN ECONOMIC DEVELOPMENT IN ASIA

Masaru Fukuda

1. Introduction

The present paper is designed to focus on some of the fundamental problems which we have experienced over the past two years since the inauguration of out Bank. The problems are indeed of the nature that the satisfactory solution for them will be very difficult and they will continue to be the existing challenge for the attention from the academic professionals in political science, economics, and social sciences for exploration of the better solution. In other words, I firmly believe that identification of the problem areas will be more important rather than the presentation of hastily made suggestions for the solution.

2. The Problem Concerning Regionalism

First of all, Asian Development Bank (ADB) is created as a regional international bank similar to the Inter-American Development Bank or the African Development Bank. That is, ADB is responsible for the overall development of Asia which is the vast area spreading from Pakistan through Indian Ocean, also following the Himalayan border i.e. Afghanistan, Nepal to Laos, and then to Southern Pacific Western Samoa and then up to Northern Pacific Korea. We might call it as the complex of different religions, cultural backgrounds, economic situations and socio-political situations. In short, ADB is responsible for the development of not only Pacific countries but also of non-Pacific countries. This fact does mean that ADB will not be conveniently placed in the position to take the clear cut policy direction for the Pacific regionalism. But we cannot also deny the fact that most of the Pacific countries, both developed and developing, are the member countries of ADB and they are naturally interested in the promotion of the development of Pacific areas. This conflicting factor which is innate in the constitutional character of ADB will be the first example of the type of the problem we must deal with carefully and certainly it will make the job of ADB management more delicate.

Secondly, another important point is the salient feature of the ADB membership which includes many non-regional countries including the United States, Canada and most of Western Europe. We are very proud of this fact. It is certainly the great strength that ADB is equipped with in comparison with other sister regional banks. This also means that ADB should always keep some appreciation of the Western climate and where possible, try to reflect their interest and wishes on our own performance. We should not also forget to appreciate the historical background where quite a number of regional developing countries used to have the very deep relationship with the West in cultural, religious, economic and other various aspects.

Thirdly, these days the so-called Southeast Asia is closing up on the scene on various occasions, like regional conferences, as a kind of the inner region within the broad region of Asia. This recognition of the particular sub-region will be somewhat natural development in various policy directions. But it also involves inherent danger towards some emotional friction, irritation or disappointments among non-sub-regional areas. This will be another area that ADB management will find itself in a very awkward situation for the impressive emphasis on certain priority direction.

After all, we must start from full recognition of the inherent difficulty inseparable from regional approach. Regional institutions are always created by the aspiration for certain regional emphasis together with some frustration from less recognition of that emphasis. However, after they are born, they will find themselves immediately in an uncomfortable situation where clear cut recognition of regionalism will often tend to lead them towards frustration by emotional explosion or gradual deterioration of keen interest within themselves.

3. Approach to Development - Three Factors

Perhaps everyone will agree, in the light of history, that breakthrough for development will be possible by the mobilization of three factors for their activation. Firstly, we must activate the passionate enthusiasm in the mind and heart of the people towards the so-called Development. Secondly, some access to modern technical know-how must be made available. This is the important area for education and technical assistance. Thirdly, on the basis of passion plus brain, monetary resources for development will be the last important factor for development. The interesting thing is we will never be blessed with the ideal combination of those three factors in the practical realities of development. The different variety of combination among those three factors will produce very interesting varieties in the pattern of development process.

(a) The first factor, the passion for Development, or the determination even on self-help basis toward development, is in my view the most important one. But it belongs outside of the function of any international institution. It might be something beyond the deliberate creation by human efforts. It just happens by the unique combination of historical developments in various aspects of certain society.

(b) Technical Assistance

Accordingly, we will start from the second factor, that is, technological know-how. This area is certainly the proper function by international development institution. International institution is indeed equipped with the powerful tactical advantage in comparison with bilateral aid agency. Through the multilateral membership construction, international institution will be able to mobilize all the different kinds of technical skills available from the wide sources. ADB is determined to be active particularly on this area and we hope we will be able to produce at least the performance not inferior to other sister institutions. I personally feel there will be reasonable hope even for better performance. Since the beginning of the ADB activity in December 1966, we have tried to respond to the many requests for technical assistance not only on loan related project like feasibility test but also on the advisory mission for broad area, for example, assisting the improved policy direction for agriculture, improved banking practice and others. Here, I would like to mention the major achievement of ADB's activity in 1967 - the Asian Agricultural Survey. Fortunately, this survey already drew substantial attention from wide academic sources in the United States and others. We will also start the Regional Transport Survey in the near future. Perhaps we can expect that more active cooperation with international institutions including research institute will be activated in the future by ADB. However, we should not overlook one problem we will face in this particular area of our function. The problem is "whether ADB is a bank or a broader development agency?". We will be exposed always to two different schools of thoughts on this question. The traditional orthodoxy will draw a certain limit to the liberal application of our resources to the active approach toward research cooperation or non-loan related technical assistance. Another school of thought will favour and endorse the positive response to the requests of cooperation from other institutions or the requests of help from developing member countries on advisory technical assistance in the wide area outside of loan activities. The former school will argue unless caution is taken, ADB will transform itself into a subsidy providing agency and precious resources will be wasted under pressures from many sources. The latter school will say the success as a bank of course is important but it is not enough, ADB is a development bank and, as such, take a broader function to help developing members improve or acquire whatever required technological skill or promote regional research cooperation.

As long as any international financial institution depends on world capital market for bond issues to get major loan resources, the management of the institution will be concerned about the reception by the investment community and the conservative orthodox banking image will tend to count. But it is also recognized that expectations on the part of regional members strongly favour and highly evaluate the broader approach.

(c) Mobilization of Monetary Resources

We now come to the third factor, that is, the mobilization of monetary development resources. Here we naturally face at present the great disadvantage in comparison with other sister institutions. We just started two years ago and our available resources are still limited particularly in relation to tremendous potential demands. However, let us examine the present situation and potential outlook. The first type of available resources will be naturally the ordinary capital resources of ADB. We have approximately one billion dollars ordinary capital, half of which should be struck out as callable capital because of its limited use for security in case we issue bonds in the future. Then the remaining half is the so-called paid-in capital, half of which is the local currency and the remaining half is the convertible currency portion. In other words, this convertible currency portion of the paid-in capital makes it immediately usable ordinary resources. As for the local currency portion, there will be the very difficult problem how to use it if the currency concerned is still inconvertible currency. There are two problems. One difficulty lies in rare opportunities to use it in settlement of foreign trade. The other is the fact that in most cases the local currency is held by the Bank not in the form of cash but in the form of notes and to use it will necessitate additional budgetary action for the country concerned, that is, leading to additional burden to the developing country. Of course, the Bank is examining and exploring the various possibilities for the use of this portion in the future. However, it is quite clear that the area for its use will be limited because of its nature. The portion of the local currency subscription by convertible currency countries will be activated in due course of time in accordance with certain limitations. But anyway our basic resources for development activities will depend on this convertible portion, that is, the one quarter of the capital which will be paid in over five years. We have already received the three installments. But it is quite clear that ADB must expand its resources by other means and the Charter of ADB already anticipated and worked out the availability of the two other additional resources, that is, the borrowed resources from bond issue in the international capital markets and the special fund contributions.

4. Problem Concerning Bond Issue

From the beginning of the Bank activities, the top management of ADB kept the great appreciation of the need for additional resources through bond issues in international capital markets and already established some solid base to the access to New York and to the centers in European capital markets. For the market in the United States, ADB is already engaged in the process of qualification for future ADB bonds in various States in the United States. Several States including New York, Massachusetts, Pennsylvania, California, and others gave the qualified status for ADB. For Europe, the top management of ADB has been in close contact with the influential banking sources in preparation for the future possible access to the European capital markets. We look forward to successful performance on the bond issue activities similar to the very active successful performance on the part of sister institutions, IBRD and IDB. However, the tendency of world capital markets under the present critical developments in the major currencies of the United States and Europe has produced certain difficulties in two points. One is the high interest rates prevailing in recent years. Anyway, although we have seen slight improvements in German market this year, the level of interest rate, we cannot deny, will be undesirably high to meet the needs of developing countries. The other difficulty will be the constant exposure of the capital markets to the present worldwide currency turmoil particularly since last year's Sterling devaluation. When we look back to the situation which prevailed in the 1940's and 1950's, one cannot help but feel the basic situation is changing to the extent that we should give more thought on the traditional approach by international institutions to recruit additional resources from private capital markets.

Things are getting more and more difficult. Of course, we do appreciate the impressive vigorous borrowing activities on the part of IBRD since the spring of 1968. Nevertheless, theoretically speaking, there is no logical relationship between the private capital markets and the development needs. The resources which will be mobilized through private capital markets could be activated but only to the extent that the private investors or banking communities in the private sector will find the investment in international institutions to be reasonably attractive and safe. Of course, the bond issues by international institutions are guaranteed by the paying capacity of member countries. More than that, in the case of IBRD, it will actually be supported more safely by IBRD practice to limit the amount of bond issue within the ceiling of callable capital subscription by the United States. In the case of IDB, it will be legally supported by similar arrangement. In the case of ADB, future bond issues will be supported by the callable capital subscription of convertible currency member countries. However, the climate of the so-called investment community is such that sometimes they are not fully satisfied with government guarantees and shift the money into portfolios which are more attractive in their eyes. But also it is a fact that in the foreseeable future, bond issues will remain to be the major method for funds recruitment for international institutions.

At this point, I must make special reference to the problem of future possibility or potential of the Pacific advanced countries for the role of capital market through private bond issues, because this conference is giving some focus on the position of advanced Pacific countries. The fact is except the United States, we do not have any real capital market in advanced Pacific countries. Canada, Australia and Japan are the main borrowing countries on the world international capital markets. One might expect the future development in Tokyo Market might make Japan as one of the major international bond market. However, in my view, it will take quite a long time to materialize this sort of dream. The status of the bond market in Tokyo is not yet developed and even the domestic bond issues in Japan including government bonds are activated through the type of private placement among the major financial institutions. Of course, one cannot say categorically any definite prophecy on this matter. But it needs some structural change in the Japanese financial systems and pattern of activities. In other words, ADB will have to recruit resources through New York and European financial centers for the time being.

5. Mobilization of ADB Special Fund Resources

Next, let us examine another type of additional resources for ADB, that is, the special fund resources. Under the Charter of ADB, we have two different types of special fund resources. One type is the special fund resources created by our own action. That is, under the Charter, up to 10 % of the paid-in capital, ADB Board of Governors will be able to create its own special fund for the purpose of low interest rate and/or with longer maturity of loan. Here we have the very limited resources but with the complete freedom from any restraint for procurement or suggestions for its use from donor countries. ADB will be able to operate on the basis of this limited type of special fund as it wishes to do. The only type of activity that ADB cannot operate on the basis of these set aside resources is the non-reimbursable grant. Anyway, ADB set aside special fund will be something like the very small scale IDA in the IBRD family in its function.

The second type of special fund resources will be the so-called contributory resources. In theory, we will be able to have the substantial future prospect of this potential additional resources if the developed member countries of ADB will respond in due course of time to the need of ADB for low interest rate, longer maturity loan activities. But in this area, we face some fundamental problems involved. It is quite understandable to expect that in human life, any donor will take action for contribution because he is interested in certain ideas or he is responsive to certain requests or he feels the same way with the organizer of the recruitment of donation for certain purpose. It is rather unrealistic to expect the donors to be responsive to any kind of donation activities. The Charter of ADB rightly appreciated this point - the initiative taken by outsiders (whether they are members or non-members of ADB to identify the priority purpose for recruitment of special fund resources and used carefully the language "accept the administration of special funds which are designed to serve the purpose and come within the functions of the bank", whereas the Charter used a different language for the set aside resources. In other words, for set aside resources, the Charter used the language " set aside .... and establish therewith one or more Special Funds"* instead

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* Article 19 "Special Funds"

1. The Bank may:

(i) set aside, by a vote of two-thirds of the total number of Goverof "accept the administration of Special Funds". The Charter did not say for the contributory resources "Who will take the action or initiative to design". It clearly means the Charter did foresee the likelihood for the initiative to be taken by someone outside the Bank itself. It is quite conceivable that certain country or countries or other international agency will take the initiative to design some special fund which is expected to be accepted by ADB for its administration after it was designed and established as some kind of international pool resources for certain purposes of development. In this case, the natural conclusion will be to expect ADB to act as a kind of trustee for the administration of pre-established fund somewhere else outside of ADB. To some extent, in this case, the function of ADB will be passive as trustee and it is expected to administer faithfully the contributed fund according to the basic agreement which was worked out by the contributors.

There will also be the variety of difference in the modes of trust agreement. In some case, the expectation by the contributors to ADB for its administration might be close to the role of executing agency, in other words, the agency which will render the technical service to provide the accounting and paying services without taking over the policy decisions. IBRD's relationship with Nam Ngum Dam project might be one example similar to this type. In other cases, major objectives might be outlined in the trust agreement and within that framework, ADB might be delegated to function as implementing trustee taking over the policy directions within that guideline. It appears very workable and understandable. However, in reality, it is not so simple. Here I must give some substantial explanation and so let us take it as a separate paragraph.

6. Operational Problems Concerning Special Fund Contributions

A. Problems Arising From Different Initiatives

(* cont'd) nors, representing at least three-fourths of the total voting power of the members, not more than ten (10) per cent each of the portion of the unimpaired paid-in capital of the Bank paid by members pursuant to paragraph 2 (a) of Article 6 and of the portion thereof paid pursuant to paragraph 2 (b) of Article 6, and establish therewith with one or more Special Funds; and

(ii) accept the administration of Special Funds which are designed to serve the purpose and come within the functions of the Bank.

If the initiative is taken by outsiders for recruitment of special fund contributions, there will be always some danger for ADB to be exposed to the competing outside initiatives to creat the special funds for the various separate objectives which will be enthusiastically supported by certain countries but looked at with skepticism or reservation or indifference by other countries. Sometimes, initiatives will be taken by advanced countries. In others, initiatives will be taken by developing countries. ADB will be exposed constantly to the pressure from various different sources. Secondly, an international institution itself is after all a living animal and does have its own taste for likes and dislikes. It always likes its own initiative, its own freedom, dislikes outside interference or suggestions and naturally, it is not in an enthusiastic mood to put itself into the modest function as faithful trustee particularly such as executing agency without any substantial say. In short, international institution's heart does not lie in that kind of activity even if its Charter writes about such function. Thirdly, even among advanced countries which are expected to be potential donors, there will be quite a different varieties of interests, sometimes conflicting each other, in the identification of the major objectives. Suppose the agricultural development is agreed upon as one of the important priorities, there will still exist quite different attitudes towards certain types of agricultural development activities. Certain advanced countries will be more enthusiastic and interested to help the family-type agriculture so that it will be made more efficient. Other donor countries might take the view that better way to modernize agriculture will be to encourage the big capitalistic plantation type of agriculture. In addition to that, if initiatives are taken by developing countries, they might be less interested in agriculture and more attracted towards the immediate industrialization skipping agriculture. Those circumstances do exist. Accordingly, we will return back to the importance of the approach by international institution to take the initiative for identifying the objective and recruit resources. However, an international institution itself is composed of various members and always the identification of priority objective will tend to be, after all, the product of ambiguous compromise among different views. On this point, if the identification of the priority objective could be worked out as a result of the scientific research done by the staff of the international institution, the situation might be simple. However, in my view, I regret to add that the present status of social sciences is neither persuasive nor objective enough to be unchallengeable. Any kind of theoretical presentation will be subject to some basic assumptions and those assumptions will invite easily some critical challenges from certain practical interests. After all, it will be most safe approach for international institution to take the position that priority will be decided according to each case by case application without declaring any clear-cut direction, or if it dares to declare, the policy declaration should be broad enough to be interpreted to suit the various different views.

Since the beginning of ADB, there were two outside initiatives. The United States took the initiative to send the bill to Congress for her contribution to the ADB Special Fund up to 200 million dollars and it was designed for four purposes, namely, agriculture, transport and communication, Mekong Development Program and educational facilities, with primary emphasis on Southeast Asia. Japan also took the initiative, through the Ministerial Conference for the Economic Development of Southeast Asia, to establish a special fund for the agricultural development in Southeast Asia. Canada also took the initiative at the Inaugural Meeting of ADB to stress the importance of concessionary financing. Netherland responded with the interest in agriculture together with its expression of strong belief on untied procurement. Denmark also responded for agriculture.

Taking into account all those conflicting difficulties which will be involved in the special fund operations, ADB Board of Directors, after lengthy discussion over the past year and a half, finally adopted the framework for our special operation, and we adopted it as the rules and regulations of Consolidated Special Funds. The main idea of this framework was to keep the balance between initiative taken by the contributors and initiative taken by the Bank. For example, the Bank established the Agricultural Special Fund, the Multi-Purpose Special Fund, Technical Assistance Special Fund and such other special funds as may be needed in the future within this consolidated framework. It was so arranged that those separate special funds will be under some common regulations which will be desirable from the Bank's standpoint. Also, in principle, repayments and interest accruals were allocated to the mult-purpose special fund unless the contributor requests to keep them in the original special fund to which they contributed. Also, repayments and interest accruals were expected to be free from tied procurement restrictions.

B. Three Different Approaches to Concessionary Financing

For international institution's financing on the concessionary terms namely the so-called soft loan, there will be two or three different types of approach. One is the traditional approach which prevailed over the past in the philosophy and operation kept by the IBRD-IDA. The other approach is something which might be possible for ADB's Special Fund operations. But I am not certain for the future direction of ADB's Special Fund operations because it is still subject to the conflicting arguments.

(i) The Approach on Balance of Payment Basis (IDA)

Even for the soft loan operation, it is clearly emphasized that the loan project itself should be of the equally sound quality and nature from the banking standpoint. The crucial difference exists only in the different status of the borrowing country in its balance of payment difficulty or in its extreme poverty in national income. Mr. Eugene Black clearly explained this philosophy when he recently visited ADB. If that is so, the next logical sequence will be that the real benefit of the soft term will not necessarily be reflected or felt at the project level, because the borrowing country will not be criticized even if it imposes the high interest rate on the project, whereas getting the soft term from the international institution. In short, the benefit of the soft term will accrue at the country level for the alleviation of its balance of payment difficulty. However, the people working at the project will not grasp or feel any impact from the great help from the international institution in the terms of lending. Another logical sequence will be that only limited number of countries will benefit from the available concessionary financing. For other cuntries, there will be no hope to have access to the soft term lending, because they are denied the benefit of access on the excuse that they are above certain level of national income or they are not in the hopeless balance of payment difficulty.

This approach will cause more problem if the excessive soft term is provided, using the extremely severe test for qualification, for example, free or 1 % interest rate with 40 or 50 years maturity only for countries ridden with extreme poverty or balance of payment difficulties. On the other hand, if the normal hard term loan is subject to the current high interest rate tendency of international capital market, the difference in terms will become wider and wider between the IBRD and IDA operations. It means something must be done for countries which do not qualify for IDA. Those problems might be less important for the worldwide responsible institution like IBRD. However, in the case of a regional bank like ADB, this will cause quite a sensitive problem among regional developing members.

(ii) The Approach on Combined Basis of Balance of Payment and Type of Project

There will be another type of approach which will be better suited to a regional bank. After all, a regional bank is responsible for all developing members regardless of the different extent of their balance of payment difficulties. In that sense, the need for the concessionary terms financing will be tested not only on the balance of payment situation, but also on the nature of the projects or programs. In other words, 3 % or 3.5 % intermediate interest rate with 20 to 25 years maturity will be quite reasonable and helpful particularly in view of current capital market situation which will cause close to 7 % loan rate to be necessary to keep the sound image of the international bank in the eyes of the international investment community. If the international institution faces the conflicting requirements, that is, it must keep the interest rate low enough to meet the developing countries' need, the answer will be naturally the blending of the hard term financing with concessionary one for all the developing member countries. This will be the logical sequence. In that case, not only the balance of payment position, but also the particular need from the certain type of project or area or problems will be the justification to apply concessionary terms. It will be convenient for the bank to keep politically the mild satissaction among all the member countries. This will be possible because every member will be able to hold at least some hope for access to concessionary resources. The weakness inherent under this approach will be, however, lack of systematic program or planned outlook, because everyting depends on case by case judgment after the Bank receives application. It was also noteworthy on this regard that strong reservation existed in the minds of the management of the Bank toward the idea to have a separate organizational unit within the Bank for Special Fund operation because they felt once such separate soft loan window is opened, every applicant will rush to it and normal loan window will be lonesome by lack of loan applicants. Under the circumstances, the Bank strongly favored the same staffs will be responsible both for normal loan operation and soft loan operation. The staff will enjoy, under this set up, a sort of commanding position toward the borrowers to tell them what portion from normal operation and what remaining portion from soft operation. The borrower will have to oblige "this blending" - the secret weapon held by the proud international institution.

(iii) Approach on Systematic Program Basis

If we could identify by some consensus prevailing among cuntries concerned the real priority for a certain sub-regional development program e.g. agricultural breakthrough in Southeast Asia to settle the food shortage problem or Mekong program, theoretically we could say that we should concentrate in systematic application of concessionary resources on the execution of this program without any regard to balance of payment positions of the borrowing countries concerned. Even if one of the developing country is currently blessed with temporary influx of U.S. dollar from military and/or other factors, it should not be denied the access to concessionary resources for that reason. In this approach, intermediate interest rate or maturity will be more adequate for practical reason. After all, if the country blessed with current foreign exchange fortune gets free interest rate with 50 years maturity, it does not make sense. The philosophy of this approach exists in the need of concessionary term not for the country but for the urgency of a certain development program which must be pushed systematically as a priority.

The original idea of Agricultural Special Fund for Southeast Asia belonged in this category of approach - this is my interpretation.

C. Problems of Procurement
(Relationship of International Liquidity and Development)

Originally, it has been taken for granted that multilateral aid through international institution should be operated on united procurement basis. Under our Charter, the procurement under ordinary operations is operated on the united procurement basis with the limitation that competitive bidding should be open only among memebrs, although there are certain exceptions. Also, the set aside resources of Special Funds will be required to be used on untied procurement basis. But for operations from special fund contributions, untied procurement requirement is not applied. United States made it clear already that the famous 200 million proposal for ADB Special Fund by U.S. contribution will be subject to balance of payment safeguards. Japan and other potential contributors might contribute on the tied procurement basis under the circumstances. Here we have some difficult problem. International institution itself is inclined to keep the untied procurement for its own operations, and is not naturally keen on the tied formula. Everyone will be familiar with the great controversy for the recent IDA replenishment with regard to this problem. But Special Fund contribution has its own more difficult problem, because contribution is made on totally voluntary ad hoc basis. It is quite different from IDA in this regard. If everybody contributes to Special Fund on certain impartial formula, there might be no problem.

Since 1960, international key currencies and other major convertible currencies have been exposed to the unprecedented monetary crisis. The problem of international liquidity and possible improvement of international monetary system has been taken up through Group of Ten leading to the recent adoption of SDR. I generally feel there is the tendency for development experts to live and think in the separate dreamy world from the reality where the monetary experts are struggling to arrest the present turmoil of major currencies under heavy speculative attack. Of course there were some ideas from Maxwell Stamp or the Prime Minister Willson to establish a bridge between the two problems but this line of thought did not win the support among responsible experts. In this regard, the following statement by the Italian Governor Colombo at the IMF Annual Meeting last September, is quite interesting and noteworthy:

> "The main deficiency, according to some, is the lack of a link between reserve creation and the provision of resources for development needs, a link which, on the contrary, exists in the present system. An improvement which could be carefully studied and eventually made, without modifying the text of the Amendment, could consist of a pledge by the main industrial countries to use the part of their reserves corresponding to a portion of their Special Drawing Rights allocations for the replenishment of IDA or for subscription to World Bank bonds".

Certainly we should explore the possibility for SDR to be used not only for IDA or IBRD but also for ADB special funds or ADB bonds subscription.

Recently, former Assistant Secretary of the U.S. Treasury, Hon. Trued, wrote in The Times of London (October 17, 1968) as follows:

> "On the economic aid front it would be tragic if the flow or rescources to the developing countries in the non-communist world were to be reduced from what are already inadequate levels. The gap between the "have" and "have not" nations continues to widen and assuredly provides grounds at some stage for serious upheaval and disorder.

Yet it is fruitless to try to extricate these operations from any general consideration of balance of payments positions. The flows of these resources have a significant payments impact. There is no way to eliminate their importance in these terms, at least as the financial system operates today.

The World Bank, and other international institutions, should be expected to recognize clearly the crucial nature of this factor so that an enlarged part of total assistance can properly be channeled through those organizations."

"The key features of the United States payments position now include (a) only a very modest trade surplus, (b) a heavy build up of liabilities abroad as essentially American corporate debt is sold to foreigners, (c) the application of extensive layers of restraints and controls and (d) a continuing overall deficit. The large trade surplus and a relatively non-inflationary economy, for long the bulwark of confidence in the dollar, have disappeared over the past three years."

Indeed, Mr. Trued made a unique point in reminding us what was the real economic basis over the past 20 years since Bretton Woods, only on which the so-called development experts could operate on the existing philosophy. If we replace his words "for long the bulwark of confidence in the dollar" with "for long the strong base for providing liberal aid without balance of payment safeguards", we will have the real insight into the present difficulty. One might think the traditional position by the U.S. might be taken over by other industrial countries like Germany and others who happen to be on a strong balance of payment position, with the result that there will not be essential difference between the past and the future. I think this is wrong because the situation among the industrialized nations other than the United States will be subject to constant fluctuation and they will be placed naturally in a position to give a close watch to safeguard their positions. It is quite different from the perennial stable structure after 1945 through 1960 where the world economy assured easily the built-in trade surplus substantially for the United States. This basic change in the pattern of performance of world economy needs to be reflected in the change of policies even on the development aid area.

Secondly, the stereo-typed recourse to "the so-called burden sharing among developed countries" will not necessarily be the easy soultion as it appears to be. As the burden is shared, leadership will also be shared. It means multiple leadership which is less obvious, more fragile, less stable than strong single leadership. International institution also needs leadership - not for the prestige of leading member, but for the efficient, effective direction of policies. This problem should be a challenge to political scientists to think over. ADB is one example of the new test case where the United States keeps far less voting power than her case with IBRD.

7. Outlook for ADB Role in Some of the New Trial Approaches

As I have explained in the foregoing paragraphs, we have come through, over the past two years, those difficult problems which are reflections of the present development of the international monetary situations. Indeed ADB came into existence at the difficult timing. We must also appreciate some weaknesses inherent in the type of an international institution like ADB which is designed to take care of general development objectives without having the pre-determined clear-cut target which will be identified in the type of set-up such as the Mekong River Development Program.

However, there is already reasonable hope for the bright outlook for regional activities in the future. One example might be the loan application from Republic of China for D.M.T. Plant on the basis of the joint sub-regional agreement with Republic of Korea on petro-chemical marketing and development. Another future possibility might be the regional joint venture for certain type of factory development which will be owned by regional developing member countries. This idea has been proposed by Prof. Rosenstein-Rodan of M.I.T. with quite an enthusiasm. Also, the ADB is already successfully getting loan participations from commerical banks in developed member countries. Last, but not least, the recent establishment of Private Investment Company for Asia S.A. (PICA) is indeed significant and it could not have been conceivable without the creation of ADB, although the cooperation between ADB and PICA is something which must be still explored in the future.

In terms of available resources, it might take still long time to project the strong image for ADB in the region compared with other sister institutions. But perhaps ADB will be able to perform the valuable function in the following ways:

(a) To keep the torch high to draw the worldwide attention to the importance of development needs of Asia.

(b) To pay more thorough and careful attention to the difficulties of the regional developing countries and extend encouraging understanding to their efforts through technical assistance.

(c) To attract the private business interests and their participation and mobilization of the resources to the direction of development led by ADB.

(d) To provide the solid base through ADB loan and other activities for the excecution of projects.

COMMENT ON MASARU FUKUDA'S PAPER BY HUGH T. PATRICK

I have found this to be both an interesting and useful paper. Essentially this is because Mr. Fukuda, rather than simply providing a descriptive history of the Asian Development Bank and its activities to date - information which is after all available in ADB publications - has taken the approach of focussing on some of the major problems the ADB has been facing and will face. He skillfully delineates the nature of the problems and major alternatives. He points out that the resolution of these problems in many instances will be an "ambiguous compromise among different views" (taking him somewhat out of context but in the right spirit, I believe, from page 299).

What I miss in the paper is Mr. Fukuda's own unofficial clear-cut views as to how these problems should be resolved, though he provides us with some hints. I appreciate that he is in an official position which may preclude him putting his own views on paper, I do hope that in this session he can feel free to speak privately and off the record; our rapporteurs should be careful not to identify him in any recording of the discussion.

The problems which Mr. Fukuda discusses can be summed up in the very name of the institution - Asian Development Bank. I will not repeat his discussion of regionalism, of what "Asian" means. One point on which I regretted lack of discussion was how the ADB is to be differentiated from the IBRD - in its rationale for being, in its objectives, functions, and operations. I suppose the rationale for being lies first in the pride of Asians in having their own institution and in the power to run it; and second, in expanding the market as it were for aid donors and bond holders. Probably the U.S. total aid commitment is slightly larger than it would have been otherwise in commiting U.S. $200 million to the ADB capital, though it has not come through yet on the agricultural special fund. I think almost certainly Japan's U.S. $200 capital subscription and agricultural contribution are real increases in its effective aid commitment. In terms of overall objectives and functions the ADB seems very close to the IBRD in other than its regional limitation; I hope this will not result in duplication of effort and higher overall costs of operation of the combined sum of IBRD plus ADB. ADB's initial loans suggest there may be some informal segmentation of the market between the IBRD and the ADB, with the ADB concentrating on small loans. Or is this simply a coincidence? I would like to hear Mr. Fukuda explain the relationship in lending operations between the IBRD and the ADB.

The main problem is the extent to which the ADB is a Development institution as distinct from being a long-term financing Bank-i.e. how broadly or narrowly the ADB defines its role. In principle, for development, it should try to adopt a broad role; engaging actively in certain kinds of technical assistance and in concessionary financing (40-50 year maturity loans at negligible interest rates). But this, if pushed strongly, runs up against a financial constraint: potential lenders to the ADB - purchasers of its bonds - will not regard it as credit-worthy and this source of funds will dry up. Since a main purpose of a development bank is to tap such market funds to intermediate between market investors and development projects - then loss of credit-worthiness is a serious problem economically, aside from the loss of prestige to the institution's bureaucrats (an important factor I suspect).

From my outsider's point of view the ADB has moved ahead rather skillfully on both fronts. As a bank it has taken an appropriately cautious and conservative approach in an effort to develop credit-worthiness. As of October 1968, it had made only four loan commitments, all fairly small, totaling U.S. $21 millions. The terms were not soft: interest rate 63/4 % (including commission) and term 12-20 years. The loans themselves are imaginative and probably very good developmentally. The first market test of ADB's credit-worthiness will come this spring when it expects to float its first bonds in European capital markets.

A future problem will be how to raise additional funds which normally are channelled through international financial markets. The ADB has moved ahead well on one function of a bank: the pooling of the risk of default, and the absorption of risk by its own capital. However, it has not yet very much taken advantage of another function of a bank: the pooling of risks of liquidity i.e. borrowing shorter-term and lending somewhat longer term. Thus far it has taken advantage of this opportunity only by selling the near-term maturities of its loans to private commerial banks.

More can and should be done in this sphere. Two possibilities, not necessarily mutually exclusive, occurred to me. First, if Professor Triffin's regional reserve system is put into effect, as he points out a fair proportion of those reserves could be invested for development purposes in the region. The ADB is the obvious institution for such a program. It could sell bonds of short to intermediate maturity to the reserve system, the amount increasing or decreasing automatically with changes in the region's (and hence the system's) total reserves. The amount would depend on the proportion or reserve deposited in the system, and the proportion of those funds available for these purposes. The system ratio of 5% suggested by Professor Triffin and a developmental proportion of 40% would imply ADB bond issue to the system of roughly U.S. $150 millions, a substantial amount.

A second alternative, which could be put into effect regardless of (and prior to) decisions concerning a payments and/or reserve system, would be to have the ADB regional members (and perhaps others) hold some proportion - say 10% - of their foreign exchange reserves in the form of short-term, convertible-currency denominated, ADB bonds or notes. The bonds could be of one-year maturity, issued quarterly. so that a country's ADB bond holdings of this type would have an average maturity of six months. An individual country's ADB bond holdings would increase or decrease automatically as reserves increased or decreased. To provide additional safeguards, a country losing substantial proportions of its reserves (in, say, a crisis) could demand automatic acceleration of liquidation on a previously developed schedule. For example, if reserves decreased by 20%, one-half of ADB bonds could be repaid, and if by an additional 20% all of its holdings.

For the area as a whole, the advantages of pooling would mean a much smaller fluctuation in region country total reserves and ADB bond holdings than for individual countries. Professor Triffin estimates that while individual ECAFE countries have had reserve losses up to 85%, the ECAFE region as a whole has had in any year a reserve loss at maximum of only 2% ! This advantage of pooling is great indeed and should not be neglected. If 10% of member country foreign exchange reserves were held in such bonds, the ADB would have additional lendable resources of more than U.S. $800 million. These probably should not be used to finance the entire portion of its long-term loans, but could well be used for near and intermediate portions of the maturity structure of the loans not sold to private financial institutions.

As a developmental institution the ADB has also moved ahead. Its technical assistance so far has been modest, it can and should be expanded. I suspect that so far the problem is more of human than financial resources. On the financial side the ADB should actively solicit funds for technical assistance projects from the UN, individual aid donors, etc.

The special funds are similar to IDA's role in the IBRD. Mr. Fukuda's opinion comes through quite clearly that the ADB has no intention of simply being the handmaiden of the special interests of donor countries. Nonetheless, the ADB should take an energetic, entrepreneurial role in developing good uses for such special funds and persuading aid donor countries to provide financial support. This would provide an opportunity to multilateralize bilateral donor aids. It might well appeal especially to smaller country donors as well as Canada, Japan, and the United States.

One issue Mr. Fukuda brings up in the matter of special fund concessionary loans is whether the criteria for countries to receive this form of aid should be balance of payments and poverty, or a sharing among <u>all</u> borrowers from the A.D.B. This is primarily a political rather than economic issue. It should be separated from the issue of low interest rates on loans to <u>projects</u> as distinguished to <u>countries</u>. The shadow price interest rate of capital in all underdeveloped countries is high, certainly more than 10%. It is very dangerous to make low interest rate loans for projects; it distorts selection of the appropriate project and capital/labor ratio technology. Where external economies exist (and they frequently are used as an excuse for low-priority projects) they will probably be undertaken by governments anyway.

I have found Mr. Fukuda's paper most stimulating and I look forward to his discussion.

COMMENT ON MASARU FUKUDA'S PAPER BY J. ENCARNACION

As Mr. Fukuda remarked at the beginning of his paper, it is a summary of some problems faced by the Asian Development Bank since the Bank started business in December 1966. The paper actually says very little about the role of ADB in economic development in Asia. It would have been interesting to know for instance, what relations might be expected between ADB and national development banks in the region.

There are two related problems noted by Mr. Fukuda which particularly interest me. First is the group decision problem - the fact that ADB has many member countries and therefore its decisions are group decisions. Second is the fact that it has multiple objectives and interests to consider in arriving at its decisions regarding possible loans for investment projects - criteria like effects on the balance of payments, growth, and employment. There is here a double problem of (a) aggregating the the individual preference systems, and (b) aggregating the multiple criteria, in such a way that the resulting decision is an " acceptable" one, or better, that it is "optimal".

I am curious as to how the Board of Directors of ADB arrives at its decisions regarding loan applications, for I have a theoretical hypothesis about group decisions involving multiple objectives which needs empirical testing. I would like Mr. Fukuda to tell us something about their decision-making in the ADB Board of Directors, and I should like to allocate any remaining time I may have to Mr. Fukuda for this purpose.

DISCUSSION OF PAPERS PRESENTED BY R. TRIFFIN AND M. FUKUDA

In reply to comments on his paper, Professor Triffin made the following points. He said that he quite agreed with Professor Johnson that his criticisms of the SDR scheme had been put too strongly. He said that the system would not necessarily weaken the present adjustment mechanism but that he felt that he would probably not strenghten it either. On the other hand, a Reserve Settlement Account could strengthen the system to the extent that support for adjustment policies would depend on whether those policies were acceptable to the group as a whole. Such a system would introduce some link between the lending by the IMF, or by the Conversion Account, and agreement on the policies which are being financed. Insofar as the adjustment mechanism depends on compatible views about the policies which have to be pursued that would be an advantage.

Professor Triffin did not share Professor Johnson's view that swap arrangements among central banks provided a very satisfactory alternative solution to recurrent monetary crises. These arrangements are sometimes very precarious, of a short term nature, and there are additional complications introduced by their bilateral character.

Professor Triffin suggested that the elimination of financial intermediation not only economized the minor costs which Professor Johnson rightly mentioned, but also had the political advantage of direct regional rather than remote international surveillance. For example, when some Latin American country has to seek assistance from the IMF, the conditions of finance are imposed by a group which is not necessarily very familiar with the particular problems of Latin America. If something goes wrong, or the conditions are unacceptable, then the Fund is subject to criticism by the region as a whole. This sort of problem could be avoided if members of the region were involved more directly in the formulation of policy conditions.

Professor Triffin agreed completely that his basic assumption was that there would be continued monetary crises. He argued that the assumption that countries would always be wise and lucky in the development of their financial policies was unrealistic. He added that he did not think it was possible to move very far in the direction of trade liberalization without having some counterpart agreement on the whole range of financial policies.

Finally, Professor Triffin said that he was very much interested in Mr. Paul's account of what had happened to his proposals since he left Bangkok. He said that he was completely baffled by the fact that it was, on the whole, the prospective creditors, such as Japan, which were cool towards the scheme initially. As Keynes pointed out, the value of an international clearing system was to generalise the advantages of a national banking system to the international economy. However, Professor Triffin said that he objected to Keynes' conclusion from this observation. An individual would not put his money into a bank which adopted the following rule: that it will lend to any Tom, Dick, and Harry on the simple demonstration that the Tom, Dick, or Harry is spending more than he is earning, and that therefore he needs money, and that he can get it automatically. There should be generous arrangements for debtors. But it is also important not to scare away the creditors. This is why Professor Triffin said that he had biased his whole scheme towards the interests of the creditor nations.

In reply to comments on his paper, Mr. Fukuda said that the relationship between the Asian Development Bank and the IBRD still had to be clarified but it was true that the ADB had so far concentrated on small or medium scale loans. He said that he was very interested in Professor Patrick's suggestions for pooling the risk of liquidity and that he would see that they were discussed thoroughly when he returned to Manila.

Mr. Fukuda said that there was very active co-operation with the various national development banks and already loans had been made to these banks in Pakistan, Thailand, and the Philippines. He concluded that the ADB was still in a formative stage, that criteria and objectives in loan-making were still being worked out, and that no clear-cut formulae had yet emerged.

Discussion of Professor Triffin's paper centered on the default procedures to be imposed under his scheme and responsibility for bearing the burden of adjustment. It was suggested that the default procedures under Triffin's plan might be too severe, and might discourage countries with large debt repayments from joining the system. Professor Triffin pointed out that, if the plan had been operating over the last ten years, Indonesia would have ended up with a $US 5 million debt to the clearing union. Repayment would have required one week of exports from Indonesia to the rest of the region. Obviously, in practice, export earnings would not be channelled off as allowed within the provisions of the scheme - various kinds of standstill agreements and lengthenings of the repayment period could be negotiated. But the position of the creditor nations with respect to Indonesia would be stronger. The mere existence of the clearing union itself would make it possible to institute much stronger guarantees against default than there could be in the absence of the union. Professor Triffin added that it also might be possible to institute guarantees for some loans from outside the region.

Another participant indicated important differences between the EPU system and the proposed ECAFE reserve system. He said that he supported the Keynesian principle implicit in the EPU that surplus countries should be required to carry the major part of the adjustment burden through increased purchases from other memebrs of the region. Professor Triffin pointed out that whether a country was in surplus within the region was not a relevant criterion for deciding how to distribute the burden of adjustments. The poorest countries might well be in surplus within the region - witness the Latin American and Eruopean cases - and they should not be forced to carry all the burdens of adjustment.

Participants from Asian countries and elsewhere discussed the role of the ADB in financing specific development projects throughout the region. They also drew attention to its potential for encouraging more effective regional specialisation, as between Korea and Taiwan, for fostering the modernization of export industries, as in Indonesia and Ceylon, and its potential for acting as the managerial agency through which something like the Triffin plan might be initiated.

Part V

EVALUATION OF AID AND TRADE POLICIES OF THE PACIFIC ADVANCED COUNTRIES TOWARDS ASIAN DEVELOPING COUNTRIES

Chapter 11

AID, TRADE AND ECONOMIC DEVELOPMENT: THE EXPERIENCE OF TAIWAN AND KOREA

Kuo-shu Liang

1. Introduction

During the period from 1952 to 1967, the real gross national product of Taiwan grew rapidly, at a cumulative annual growth rate of 8.4 per cent. The record has made Taiwan one of the relatively few developing countries with highly sustained growth since the 1950's. Table 1 shows the absolute levels and the annual growth rates of real gross national product of Taiwan. The relatively low growth rates in 1956 and 1960 were mainly attributable to the typhoon and drought damages. However, the economic growth during the period under review was on the whole exceptionally steady and free from setback.

Needless to say, Taiwan has encountered certain formidable problems in the course of its development, namely, a small island economy and limited natural resources, more than three per cent per annum of the natural increase in its population, and the heavy burden of military expenditures which formed around ten per cent of GNP. But as pointed out by Professor Jacoby, there were six strategic conditions which contributed to Taiwan's rapid growth in recent years.[1] They were: (a) the native talents and industry of the literate local people, (b) the infrastructure and human resource foundation laid by Japan, (c) the administrative and professional cadres filled by emigrants from Mainland China, (d) a stable government, (e) policies favorable to private enterprises, including relative monetary stability, and (f) U.S. economic aid.

When the foundation of infrastructure, human resources, stable political institutions, and constructive economic policies have been laid, the final element necessary to make the country grow rapidly will be an ample supply of material resources and new technology. In the course of Taiwan's economic development, the last factor was supplied at the critical time by U.S. aid.

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1 N. H. Jacoby, U.S. Aid to Taiwan: A Study of Foreign Aid, Self-Help, and Development, (New York: Frederick A. Praeger, 1966), p. 240.

Table 1

Real Gross National Product of Taiwan
(at constant prices of 1964)

Year	Amount (NT$ million)	Growth Rate (%)
1952	40,698	-
1953	44,472	9.3
1954	47,776	7.4
1955	51,745	8.3
1956	54,189	4.7
1957	58,155	7.3
1958	62,327	7.2
1959	66,952	7.4
1960	71,177	6.3
1961	76,736	7.8
1962	82,272	7.2
1963	90,314	9.8
1964	102,492	13.5
1965	115,228	12.4
1966	126,007	9.4
1967	137,184	8.9

Source: Directorate-General of Budgets, Accounts & Statistics, Executive Yuan, National Income of the Republic of China, (Taipei, Taiwan).

In this paper, I will first examine the contributions of U.S. aid program to Taiwan's economic development. I then portray some of the structural characteristics of Taiwan's foreign trade so as to see how successful the Republic of China has been in offsetting its disadvantages of small size through the expansion of foreign trade. Finally, a brief contrast is made between the economic performances of Taiwan and Korea in recent years.

II. U.S. Aid and Taiwan's Economic Development

During the postwar period, especially years 1949-51, the prewar production level was restored, and there was the timely resumption of U.S. economic aid to the Republic of China in the later part of 1950 after the outbreak of the Korean war. Taiwan was the beneficiary of a "rich" aid program. A total of US$1,473.6 million had been appropriated over the fifteen fiscal years, 1951-65, amounting to an average of almost US$100 million a year. Consequently, aid obligations averaged about 7.5 per cent of Taiwan's GNP over the entire period,[2] and was equivalent to about US$10 per capita per year. Table 2 shows the annual breakdown of obligation and arrival amounts.

Table 2

Obligation and Arrival Amounts of U. S. Aid
(unit: US$ million)

Year	Obligation Amount	Arrival Amount
FY 1951	83.4	375.2
1952	82.9	
1953	100.6	
1954	108.3	
1955	132.0	132.0
1956	101.6	101.6
1957	108.1	108.1
1958	81.6	81.6
1959	128.9	128.9
1960	102.9	100.1
1961	94.8	94.2
1962	67.9	63.7
1963	120.1	114.2
1964	100.4	57.3
1965	60.1	45.9
Total	1,473.6	1,402.8

Source: Council for International Economic Cooperation and Development, Executive Yuan, Taiwan Statistical Data Book, 1967, (Taipei, Taiwan), pp. 133-4, Tables 11-3-4.

2 GNP was measured in NT dollars at 1964 prices as shown in Table 1, and then converted at the official exchange rate of NT$40 to US$1.

Table 3

Financial Sources of Gross Domestic Capital Formation

(unit: NT$ million)

Year	Gross Domestic Capital Formation	Provision for Consumption of Fixed Capital		Saving		Inflow of Foreign Funds		Statistical Discrepancy
	(1)	(2)	(2)/(1)	(3)	(3)/(1)	(4)	(4)/(1)	
1952	2,643	827	31.3%	697	26.4%	1,068	40.4%	51
1953	3,224	1,063	33.0	890	27.6	1,192	37.0	79
1954	4,041	1,259	31.2	733	18.1	2,126	52.6	-77
1955	3,998	1,504	37.6	1,099	27.5	1,317	32.9	78
1956	5,524	1-835	33.2	1,346	24.4	2,390	43.3	-47
1957	6,355	2,346	36.9	1,665	26.2	2,131	33.5	213
1958	7,898	2,622	33.2	1,637	20.7	3,503	44.4	136
1959	9,768	3,239	33.2	1,733	17.7	4,505	46.1	291
1960	12,587	4,037	32.1	3,380	26.8	4,817	38.3	353
1961	13,931	4,380	31.4	4,522	32.5	5,082	36.5	-53
1962	14,444	4,739	32.8	5,098	35.3	5,200	36.0	-593
1963	15,226	5,737	37.7	8,560	56.2	929	6.1	-
1964	19,248	6,579	34.2	12,780	66.4	151	0.8	-262
1965	25,507	6,962	27.3	14,960	58.7	4,502	17.6	-917
1966	28,879	7,840	27.1	18,874	65.4	1,651	5.7	514

Source: DGBAS: op. cit.

U.S. aid not only reduced inflationary pressure, but also filled the gap between capital requirements for plan target and domestic capacity to save and invest. Financial sources of gross domestic capital formation are presented in Table 3. Gross domestic capital formation had depended on inflow of foreign funds (most of which were U.S. aid) to a very high degree before 1962. In addition, aid recipient firms were required to invest their own funds in projects, so that aid dollars had a direct multiplier effect. Without massive assistance from the United States which formed the major part of inflow of foreign funds, the economy of Taiwan would not be able to grow so rapidly as it experienced.

In this connection, the contribution of the aid generated local currency fund is worth while mentioning. The Local Currency Program was used to support military budget as well as to finance local development projects. Since the aid generated local currency fund functioned in the same way as an additional tax revenues to the government, the fund made it possible for the government to carry on an ambitious program of public investment without raising the tax level. The fund also enabled the government to offer tax reduction in 1960 as an incentive to business investment, and raised the level of domestic capital formation.[3] There was definite advantages in the generation of local currency funds through aid imports. After the termination of U.S. aid, the unallocated local currency fund was paid into a newly established Sino-American Fund for Economic and Social Development to be administrated by the Chinese government.

Viewed in relation to Taiwan's international trade, the deficits on the total trade balance were more or less covered by transfer payments, most of which were U.S. aid in the form of grant before 1962. However, U.S. aid diminished in importance in the balance of payments of Taiwan toward the end of the period under review, and that the inflow of foreign capital begun to play a greater part. The Balance of Payments of the Republic of China is shown stability/security-oriented. As shown in Table 6, U.S. aid commodities that arrived during this period were mostly composed of industrial and agricultural raw materials, namely, raw cotton, wheat, soybean, petroleum, fertilizer, and pesticide. These imported raw materials were used to support domestic production, and had a stronger and more immediate anti-inflationary impact than capital projects would have had.

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3 Jacoby, op. cit., p.211.

Table 4

Balance of Payments, the Republic of China
(unit: US$ million)

		1952	1953	1954	1955	1956	1957	1958	1959
A.	Goods and Services								
	Exports	119.52	128.61	100.54	127.47	124.12	148.29	156.58	157.21
	Imports	-205.42	-192.92	-209.57	-185.07	-222.05	-244.69	-273.49	-268.14
	Nonmonetary Gold	1.91	1.62	1.34	0.53	1.54	0.87	1.26	- 2.14
	Commodity Trade Balance	- 83.99	- 62.69	-107.69	- 57.07	- 96.39	- 95.53	-115.65	-113.07
	Services	- 11.37	- 17.80	- 28.07	- 14.72	- 11.14	- 0.75	- 7.29	- 12.81
	Total Trade Balance	- 95.36	- 80.49	-135.76	- 71.79	-107.53	- 96.28	-122.94	-125.88
B.	Transfer Payments								
	U.S. Aid - Grants	92.55	84.32	92.73	90.67	65.15	58.27	86.92	76.23
	Other Transfer Payments	2.47	2.42	- 0.06	1.34	- 0.38	0.13	10.72	0.03
	Total	95.02	86.74	92.67	92.01	64.77	58.40	97.64	76.26
C.	Current Balance (A + B)	- 0.34	6.25	- 43.09	20.22	- 42.76	- 37.88	- 25.30	- 49.62
D.	Long-term Capital	- 0.60	4.36	6.31	4.07	23.26	39.74	10.17	8.66
E.	Basic Balance (C + D)	- 0.94	10.61	- 36.78	24.29	- 19.50	1.86	- 15.13	40.96
F.	Errors & Omission	2.83	5.41	- 0.37	2.80	- 7.87	- 0.79	5.05	6.76
G.	Short-term Capital	0.02	- 14.40	38.49	- 25.92	28.94	- 0.20	30.38	28.83
H.	Overall Balance (E + F + G)	1.91	1.62	1.34	1.17	1.57	0.87	20.30	- 5.37
I.	Official Gold and Foreign Exchange	- 1.91	- 1.62	- 1.34	- 1.17	- 1.57	- 0.87	- 20.30	5.37

Source: The Economic Research Department, the Central Bank of China, Balance of Payments, the Republic of China.

Note: Export value: f.o.b.; import value: c.i.f. for 1952-63, f.o.b. since 1964.

Table 4 (Cont'd)

		1960	1961	1962	1963	1964	1965	1966	1967
A.	Goods and Services								
	Exports	164.00	196.25	218.20	332.01	434.54	450.77	542.74	653.68
	Imports	-286.52	-330.32	-341.00	-327.53	-407.81	-522.76	-585.56	-716.30
	Nonmonetary Gold	- 0.66	0.22	- 0.29	3.70	0.39	- 0.39	0.45	1.00
	Commodity Trade Balance	-123.18	-133.85	-123.09	8.18	27.12	- 72.38	- 42.37	- 61.62
	Services	- 6.71	3.08	- 3.01	- 14.97	- 22.16	- 29.00	13.07	- 9.32
	Total Trade Balance	-129.89	-130.77	-126.10	- 6.79	4.96	-101.38	- 29.30	- 70.94
B.	Transfer Payments								
	U.S. Aid - Grants	89.16	98.44	55.76	46.14	24.21	26.09	11.90	4.61
	Other Transfer Payments	- 0.90	- 0.02	- 0.91	- 1.44	- 4.08	6.78	11.79	19.67
	Total	88.26	98.42	54.85	44.70	20.13	32.87	23.69	24.28
C.	Current Balance (A + B)	- 41.63	- 32.35	- 71.25	37.91	25.09	- 68.51	- 5.61	- 46.66
D.	Long-term Capital	63.50	32.78	17.62	39.66	30.23	63.98	62.88	136.35
E.	Basic Balance (C + D)	21.87	0.43	- 53.63	77.57	55.32	- 4.53	57.27	89.69
F.	Errors & Omission	5.31	- 1.43	- 3.06	- 2.12	- 7.70	6.15	- 3.45	7.36
G.	Short-term Capital	- 4.05	19.26	38.90	29.59	17.89	- 13.11	15.91	- 37.95
H.	Overall Balance (E + F + G)	23.13	18.28	- 17.79	105.04	65.51	- 11.49	69.73	59.10
I.	Official Gold and Foreign Exchange	- 23.13	- 18.28	17.79	-105.04	- 65.51	11.49	- 69.73	- 59.10

Table 5

Ordinary and U.S. Aid Imports

(unit: NT$1,000)

Year	Total Imports (1)	Ordinary Imports Amount (2)	Ordinary Imports Percentage (2)/(1)	U.S. Aid Imports Amount (3)	U.S. Aid Imports Percentage (3)/(1)
1952	2,532,780	1,768,210	69.82	764,570	30.18
1953	2,754,305	1,655,200	60.09	1,099,106	39.91
1954	3,303,678	1,807,424	54.71	1,496,254	45.29
1955	3,145,998	1,626,971	51.72	1,519,027	48.28
1956	4,799,792	2,802,842	58.40	1,996,950	41.60
1957	5,259,378	3,190,326	60.66	2,069,052	39.34
1958	5,604,940	3,947,562	70.43	1,657,378	29.57
1959	8,419,831	5,871,387	69.74	2,548,444	30.26
1960	10,796,868	6,848,740	63.43	3,948,127	36.57
1961	12,894,294	8,346,744	64.73	4,547,550	35.27
1962	12,173,537	9,154,733	75.20	3,018,804	24.80
1963	14,483,366	11,311,733	78.10	3,171,633	21.90
1964	17,161,449	15,354,260	89.47	1,807,189	10.53
1965	22,296,043	19.754,257	88.60	2,541,787	11.40
1966	24,956,663	23,875,791	95.67	1,080,872	4.33

Source: The Statistical Department, Inspectorate General of Customs, The Trade of China, Net Imports from Foreign Countries: Value of Merchandise by Groups.

Table 6
Composition of U.S. Aid Commodities Arrived

Year	Capital Goods	Raw Materials	Consumption Goods
1951 ~ 55	14.0%	81.8%	4.2%
1956 ~ 60	27.7	64.8	7.5
1961 ~ 65	21.0	71.9	7.1
Total	21.1	72.6	6.3

Source: CIECD: Taiwan Statistical Data Book, 1967, p.140, Table 11-4.

In 1953, the Chinese government launched its First Four-Year Economic Plan, the objective of aid also gradually shifted from stability/security-oriented to development-oriented. As a result, the middle aid period of years 1956-60 was marked by heavy commitments to infrastructure (electric power and transportation), human resources, and industrial projects as shown in Tables 7 and 8. Much aid to industry went to the public enterprises. But aid was also a catalytic financial element in such private industries as glass, synthetic fibres, polyvinyl plastics, hardboard, soda ash, and cast iron pipe. It can also be observed from Table 6 above that there was a considerable increase in the percentage of capital goods imports during this period.

Finally, with the industrialization process gained momentum, the late aid period of years 1961-65 was marked by an increasing emphasis upon the aims of fostering private enterprises, promoting exports, and terminating U.S. aid.

The establishment of the Industrial Development and Investment Center and of the China Development Corporation in 1959 reflected the shift in the aid policy which put more emphasis on private enterprises.[5]

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5 Public enterprises are actually hardly likely to be at its best in selling exportables in the world market. These enterprises are difficult to attain initiative, flexibility, and risk taking.

Table 7

Allocation of Project-type U.S. Aid - by Industry

Year	Total	Agriculture	Mining and Manufactures	Electric Power and Transportation	Human Resources	Others
I. Amount (US$1,000)						
FY1951-55	110,428	5,237	35,663	44,819	3,750	20,959
1956-60	192,289	27,506*	48,670	82,514	10,731	22,868
1961-65	55,174	1,577	8,017	38,580	3,689	3,311
Total	357,891	34,320	92,350	165,913	18,170	47,138
II. Percentage						
FY1951-55	100.0	4.7	32.3	40.6	3.4	19.0
1956-60	100.0	14.3*	25.3	42.9	5.6	11.9
1961-65	100.0	2.9	14.5	69.9	6.7	6.0
Total	100.0	9.6	25.8	46.4	5.1	13.2

Source: CIECD: Taiwan Statistical Data Book, 1967, p. 136, Table 11-6.

Notes: Human resources sector includes education, health and sanitation, and public administration.

* Including loan for Shihmen Dam and Reservoir Development Project.

Table 8

Allocation of U.S. Aid Generated Local Currency Fund

Year	Total	Agriculture	Mining and Manufactures	Electric Power and Transportation	Human Resources	Direct Military Force Support	Others
I. Amount (NT$ million)							
FY1952-55	3,712.1	713.9	197.7	602.5	184.6	1,772.5	240.9
1956-60	11,093.5	1,623.2	1,497.7	2,204.7	1,199.9	3,694.7	874.2
1961-65	15,483.4	2,354.3	1,128.5	1,852.6	1,078.5	5,487.4	3,582.1
1966-67*	4,606.6	898.5	915.5	1,788.2	370.0	-	634.4
Total	34,895.6	5,589.9	3,739.4	6,448.0	2,832.1	10,954.6	5,331.6
II. Percentage							
FY1952-55	100.0	19.2	5.3	16.2	5.0	47.7	6.5
1956-60	100.0	14.6	13.5	19.9	10.8	33.3	7.9
1961-65	100.0	15.2	7.3	12.0	7.0	35.4	23.1
1966-67*	100.0	19.5	19.9	38.8	8.0	-	13.8
Total	100.0	16.0	10.7	18.5	8.1	31.4	15.3

Source: CIECD: Taiwan Statistical Data Book, 1967, p. 138, Table 11-8a.

Note: * A newly established Sino-American Fund for Economic and Social Development.

The Third Four-Year Plan for "accelerated economic development" during 1961-64 was announced by the Chinese government in January, 1960. Laws and regulations governing investment were liberalized, the multiple exchange rate system was unified and stabilized in 1961 at the rate of 40 NT dollars to 1 US dollar. Since Taiwan possessed abundant efficient labor and has a strategic location, U.S. aid and the constructive government policies helped to create a favorable investment climate and booming private sector. Table 9 shows private and public output as percentage of industrial production. Industry in Taiwan underwent a startling diversification, foreign trade was expanded especially after 1963 as shown in Table 4 above, and at the same time, the Republic of China succeeded in attracting foreign investments and technical assistance from the United Nations and other broader sources. By 1965, Taiwan was in a position to move forward without any substantial concessinal assistance from the United States.

The above mentioned change in emphasis on the aid policy was basically sound and in a correct sequence. In the following section, I will discuss the major trends and changes in the composition of Taiwan's foreign trade.

Table 9
Private and Public Output as Percentage of Industrial Production

Year	Private Output	Public Output
1952	42.7%	57.3%
1953	43.0	57.0
1954	48.7	51.3
1955	49.5	50.5
1956	49.9	50.1
1957	49.2	50.8
1958	51.8	48.2
1959	53.0	47.0
1960	54.2	45.8
1961	60.1	39.9
1962	61.1	38.9
1963	61.9	38.1
1964	64.3	35.7
1965	65.6	34.4
1966	68.2	31.8

Source: CIECD: Taiwan Statistical Data Book, 1967, p.44, Table 5-4.

III. MAJOR TRENDS AND CHANGES IN THE COMPOSITION OF TAIWAN'S FOREIGN TRADE

The foreign trade sector has played an important role in Taiwan. Table 10 shows the ratios of exports and of imports to gross domestic product at current prices. The ratio of exports to GDP increased steadily, and both ratios exceeded twenty per cent in 1966. Taiwan is certainly a trade-limited economy.

In absolute terms, real exports recorded six times increase and real imports more than three times during the period of years 1952-66 as shown in Table 11. In other words, real exports grew very rapidly at a cumulative annual growth rate of 12.5 per cent during the period. This rate far exceeded that of GDP, i.e., 8.4 per cent per annum. On ther other hand, real imports grew at a cumulative annual growth rate of 8.7 per cent which was very close to that of GDP. We can say that real imports and GDP showed a parallel increase.

Table 10
Exports and Imports as Percentage of GDP
(in NT$ million at current prices)

Year	GDP	Exports of Goods and Services		Imports of Goods and Services	
	(Y)	(X)	(X)/(Y)	(M)	(M)/(Y)
1952	17,251	1,385	8.0%	2,438	14.1%
1953	22,992	1,977	8.6	3,163	13.8
1954	25,229	1,631	6.5	3,738	14.8
1955	30,091	2,469	8.2	3,764	12.5
1956	34,550	3,097	9.0	5,456	15.8
1957	40,346	3,823	9.5	5,879	14.6
1958	44,778	5,185	11.6	8,646	19.3
1959	51,749	6,429	12.4	10,880	21.0
1960	62,566	7,033	11.2	11,726	18.7
1961	69,867	8,991	12.8	13,868	19.8
1962	76,595	10,064	13.1	14,990	19.6
1963	87,482	15,444	17.7	15,919	18.2
1964	102,649	19,202	18.7	18,812	18.3
1965	113,441	20,806	18.3	24,493	21.6
1966	125,825	26,065	20.7	27,035	21.5

Source: DGBAS: op. cit.

In order to get a clearer idea about the recent expansion in exports and imports, we have to go further to look into their respective composition. As shown in Table 12, the percentage of export value of industrial products to total exports rose from 3.6 per cent in 1952 to 49.2 per cent in 1966.

Table 11
GDP, Exports, and Imports
(in NT$ million at constant prices of 1964)

Year	GDP		Exports of Goods and Services		Imports of Goods and Services	
	Amount	Index Number	Amount	Index Number	Amount	Index Number
1952	40,712	100.0	4,784	100.0	7,655	100.0
1953	44,483	109.3	5,753	120.3	8,181	106.9
1954	47,786	117.4	4,320	90.3	8,619	112.6
1955	51,752	127.1	5,333	111.5	7,246	94.7
1956	54,202	133.1	5,768	120.6	9,011	117.7
1957	58,255	143.1	6,545	136.8	9,397	122.8
1958	62,364	153.2	7,968	166.5	11,288	147.5
1959	66,976	164.5	8,327	174.1	11,550	150.9
1960	71,182	174.8	9,588	200.4	12,372	161.6
1961	76,810	188.7	10,947	228.8	13,642	178.2
1962	82,394	202.4	11,838	247.4	15,121	197.5
1963	90,460	222.2	15,740	329.0	15,606	203.9
1964	102,649	252.1	19,202	401.4	18,812	245.7
1965	115,557	283.8	24,038	554.5	23,830	311.3
1966	126,336	310.3	28,579	597.4	24,793	323.9

Source: DGBAS: op. cit.

Table 13 below shows that the percentage contribution of the manufacturing industry to net domestic product increased steadily at the expense of that of agriculture, while the position of the mining and other industries remained more or less unchanged. The Taiwan economy had undergone transformation toward industrialization in the course of its economic development during the period under review, and the transformation had a direct bearing on the changes in the structure of Taiwan's exports.

Many factors are responsible for this expansion in manufacturing sector and exports of manufactured goods. Of which the most important is the extension of the process of import substitution to

Table 12

Composition of Exports

(unit: US$1,000)

Year	Total	Agricultural Products		Processed Agricultural Products		Industrial Products		Others	
		(2)	(2)/(1)	(3)	(3)/(1)	(4)	(4)/(1)	(5)	(5)/(1)
1952	119,527	32,194	26.9%	81,637	68.3%	4,328	3.6%	1,368	1.2%
1953	129,793	17,019	13.1	103,275	79.6	8,288	6.4	1,211	0.9
1954	97,756	14,481	14.8	75,571	77.3	6,665	6.8	1,039	1.1
1955	133,441	39,600	29.7	83,582	62.6	8,193	6.1	2,066	1.6
1956	130,060	19,504	15.0	93,343	71.7	15,454	11.9	1,759	1.4
1957	168,506	28,071	16.6	125,820	74.7	12,066	7.2	2,549	1.5
1958	164,433	39,135	23.8	103,725	63.1	18,571	11.3	3,002	1.8
1959	160,540	38,460	24.0	86,088	53.6	33,575	20.9	2,417	1.5
1960	169,866	19,847	11.7	95,014	55.9	51,674	30.4	3,331	2.0
1961	214,041	32,731	15.3	91,405	42.7	84,978	39.7	4,927	2.3
1962	238,609	33,045	13.8	85,821	36.0	112,555	47.2	7,188	3.0
1963	357,524	51,176	14.3	154,160	43.1	141,164	39.5	11,024	3.1
1964	463,110	74,192	16.0	186,992	40.4	184,629	39.9	17,297	3.7
1965	487,959	133,794	27.4	132,771	27.2	201,633	41.3	19,761	4.1
1966	569,426	131,958	23.2	129,293	22.7	280,444	49.2	27,731	4.9

Source: CIECD: Taiwan Statistical Data Book, 1967, p. 123, Table 10-5.

Note: The table is compiled from the data of export exchange settlement, the Bank of Taiwan.

Table 13
Percentage Distribution of New Domestic Product by Industrial Origin
(at current prices)

Year	Agriculture	Mining	Manufacturing	Others	Less: Adjustment for Imputed Interest
1952	35.7%	2.1%	10.8%	51.7%	0.3%
1953	38.0	1.7	11.2	49.4	0.3
1954	31.5	1.8	14.4	52.6	0.3
1955	32.5	1.7	13.7	52.6	0.5
1956	31.2	2.2	14.4	52.8	0.6
1957	31.3	2.6	15.5	51.2	0.6
1958	31.0	2.9	15.4	51.5	0.8
1959	30.3	2.5	17.6	50.2	0.6
1960	32.5	2.3	16.7	49.1	0.6
1961	31.3	2.1	16.9	50.0	0.3
1962	29.2	2.6	17.1	51.4	0.3
1963	26.7	2.1	19.6	51.9	0.3
1964	27.7	1.8	20.2	50.6	0.3
1965	26.9	2.1	18.7	52.7	0.4
1966	25.8	2.2	19.1	53.3	0.4
1967	24.4	2.3	20.1	53.5	0.3

Source: DGBAS: op. cit.

export promotion, particularly for textiles and clothing, plywood, plastics and manufactures thereof, iron and steel, cement, fertilizer, plate glass, monosodium glutamate, and wheat flour.

The process of import substitution to export promotion is to a considerable extent a matter of economic environments and policies. Direct steps were taken by the government to protect and foster domestic industry. The land reform resulted in the increase in rural income, and thus expanded the extent of the home market. Even because of the overvalued exchange rate in 1950's, industrial investments became more attractive. With the industry in Taiwan underwent a startling expansion and diversification, measures were then taken to encourage import substituting industries to export their products under a relative monetary stability. The timely unification and simplification of foreign exchange rates effected between 1958 and 1961 has assured the exporters of stable and reasonable earnings. Tax incentives including exemption from business tax for all export transactions and from import duties on raw materials to be processed for exports, as well as special low interest loans applicable only to export manufacturers have strengthened the competitive capacity of Taiwan's products in the world market. Specific measures have also been adopted to encourage the manufacturers of cement, textiles, papers, and monosodium glutamate to make joint efforts to expand exports. In the case of textile industries, 20 per cent of C.I.F. prices of imported raw cotton has been collected as the cooperative fund to be refunded after the textile products are exported. In addition, a 5 per cent bounty is paid on exports. Such measures have stimulated the manufacturers concerned to be more export-oriented.

At the same time, the erection of a tax-and-duty-free industrial processing zone in 1965 and the liberalization of exchange control have encouraged foreign investments and joint-ventures in export-oriented industries, such as electronic products, stainless curtley, clothing, and toys. The favorable investment policies combined with an ample supply of cheap and efficient labor have made Taiwan an attractive site for footloose labor-intensive manufacturing industries.

As for the exports of processed agricultural products and agricultural products, there were the emergence of new export-oriented products such as canned mashroom, canned asparagus, as well as the increase in traditional exports such as canned pineapple, canned bamboo shoots, citronella oil, and banana. However, the weight of the exports of both products taken together showed a substantial decrease during the period. It is particularly noteworthy that the exports of the two major tranditional products - sugar and rice - had decreased in relative importance. As shown in Table 14, the exports of other products had enjoyed a continual expansion, their total value in 1966 was 17.8 times as large as that of 1952. It is also apparent that the export values of sugar and rice had undergone violent fluctuations. These fluctuations reflect the well-known facts that the sugar price had been subject to erratic changes in the world market, while the exportable surplus of rice was highly sensitive to variation in harvest. Increase in domestic consumption due to rapid increase in population may reduce the exportable surplus of rice in future.

Table 14

Exports of Sugar, Rice and Other Products

(unit: US$1,000)

Year	Total	Sugar		Rice		Others	
	(1)	(2)	(2)/(1)	(3)	(3)/(1)	(4)	(4)/(1)
1952	119,527	69,684	58.3%	23,240	19.4%	26,603	22.3%
1953	129,793	90,255	69.5	11,354	8.8	28,184	21.7
1954	97,756	58,636	60.0	7,844	8.0	31,276	32.0
1955	133,441	67,920	50.9	32,764	24.6	32,757	24.5
1956	130,060	76,060	56.5	12,837	9.9	41,163	33.6
1957	168,506	110,783	65.7	21,238	12.6	36,485	21.7
1958	164,433	84,689	51.5	28,621	17.4	51,123	31.1
1959	160,540	65,929	41.1	23,506	14.6	71,105	44.3
1960	169,866	74,401	43.8	4,320	2.5	91,145	53.7
1961	214,041	61,096	28.5	10,080	4.7	142,865	66.8
1962	238,609	49,588	20.8	7,380	3.1	181,641	76.1
1963	357,524	105,983	29.7	23,355	6.5	228,186	63.8
1964	463,110	135,403	29.2	18,031	3.9	309,676	66.9
1965	487,959	67,956	13.9	42,955	8.8	377,048	77.3
1965	569,426	61,709	10.8	32,966	5.8	474,751	83.4

Source: CIECD: Taiwan Statistical Data Book, 1967, p. 124, Table 10-6.

Note: The table is compiled from the data of export exchange settlement, the Bank of Taiwan.

Table 15

Composition of Imports

(unit: US$1,000)

Year	Total	Capital Goods		Agricultural and Industrial Raw Materials		Consumption Goods	
	(1)	(2)	(2)/(1)	(3)	(3)/(1)	(4)	(4)/(1)
1952	206,980	27,115	13.1%	153,482	74.2%	26,383	12.7%
1953	190,597	32,988	17.3	130,731	68.6	26,878	14.1
1954	203,976	39,376	19.3	140,927	69.1	23,673	11.6
1955	190,065	35,339	18.6	135,419	71.2	19,307	10.2
1956	228,225	55,076	24.1	155,100	68.0	18,049	7.9
1957	252,235	66,632	26.4	165,965	65.8	19,638	7.8
1958	232,785	60,200	25.9	146,501	62.9	26,084	11.2
1959	244,350	75,980	31.1	149,502	61.2	18,868	7.7
1960	252,216	69,489	27.5	158,835	63.0	23,892	9.5
1961	324,050	91,952	28.4	193,644	59.7	38,454	11.9
1962	327,542	84,354	25.7	211,536	64.6	31,652	9.7
1963	336,787	82,936	24.6	225,580	67.0	28,271	8.4
1964	410,401	102,491	25.0	264,861	64.5	43,049	10.5
1965	556,402	163,873	29.5	349,181	62.7	43,348	7.8
1966	603,109	178,871	29.6	376,107	62.4	48,131	8.0

Source: CIECD: Taiwan Statistical Data Book, 1967, p. 126, Table 10-8.

Note: The table is compiled from the data of import exchange settlement, the Bank of Taiwan, and includes bank's exchange settlements, U.S. aid, and others.

The expansion of industrial production necessarily led to the substitution for some imported goods on the one hand, and gave rise to increase in the demand for some other imported goods on the other, thus caused changes in the composition of imports. As shown in Table 15, consumption goods as well as agricultural and industrial raw materials fell in the first category where import substitution had taken place. Chemical fertilizers afford a striking example. Their import value was about thirty six million US dollars in 1952, but decreased to less than fifteen million US dollars in 1966 as a result of government's efforts to increase their production. In fact, some urea has been exported recently. In contrast, both the value and the share of capital goods in total imports registered considerable increase during the period under review. The development of import substituting industries in itself has set up additional demands for imports of capital goods.

Table 16
Net Barter and Income Terms of Trade
(Monthly Average of 1961 = 100)

Year	Net Barter Terms of Trade (1)	Export Quantum Index (2)	Income Terms of Trade (1) x (2)
1952	114.18	59.35	67.76
1953	111.92	88.95	99.55
1954	108.43	61.51	66.70
1955	111.33	76.42	85.51
1956	110.95	73.87	81.96
1957	117.61	86.03	101.18
1958	105.31	104.95	110.52
1959	102.21	98.94	101.13
1960	95.43	97.09	92.28
1961	100.00	100.00	100.00
1962	99.45	113.81	113.18
1963	120.12	141.04	169.42
1964	126.80	185.37	235.05
1965	96.87	211.21	204.26
1966	91.14	253.84	231.35
1967	96.67	256.50	248.00

Source: Department of Statistics, Ministry of Finance, Taiwan Bi-monthly Statistics of Foreign Trade, (Taipei, Taiwan).

Finally as regards the terms of trade, we can see from Table 16 that the net barter terms did not show any definite trend during the period under review. It is to our satisfaction that the income terms showed a significant improvement especially after 1962. The increase in physical exports caused a roughly parallel increase in export-based capacity to import.

IV. THE CONTRAST BETWEEN TAIWAN AND KOREA

From the above analysis, it is obvious that, contrary to the widely held pessimistic view about the prospect of small overpopulated island economies, Taiwan recorded a substantial domestic growth and a substantial degree of expansion of exports during the period under review. Another notable successful case of the relatively few developing countries that have embarked upon a phase of sustained growth in recent years is the Korean economy.

It is interesting to note that the two economies have much in common.[6] Both possess intelligent and industrious population. Neither are favored with abundant natural resources. Both underwent a lengthy developmental process under the colonial rule of Japan, during which they acquired considerable investments in infrastructure and education. Both were confronted by overt military threats. Therefore, both countries received huge amounts of U.S. assistance. During the period of years 1953-66, the United States extended aid to Korea in the amounts of 6,538.8 million US dollars.[7] The share of aid-financed imports in total imports of Korea had been kept above fifty per cent before 1962 as shown in Table 17.

Despite these similarities, some factors can be identified to account for Taiwan's earlier shift from the stability/security-oriented aid as well as economic policies to the development-oriented ones.[8] They are:

(1) Taiwan benefited from five years of additional peace. Whereas Taiwan enjoyed internal peace after 1949, Korea suffered from the split in Agricultural South and Industrial North and the destructive warfare during 1950-53.

6 Jacoby, op. cit., p. 158.

7 G. Ranis, "U.S. Aid Policies in Asia," in K. Kojima (ed.), Pacific Trade and Development, (Tokyo: The Japan Economic Research Center, 1958), p. 336 and p. 340.

8 Jacoby, op. cit., pp. 159 - 60.

Table 17
Total Imports and Aid-Financed Imports in Korea
(unit: US$ million)

Year	Total Imports (1)	Aid-Financed Imports Amount (2)	Aid-Financed Imports Percentage (2) / (1)
1953	345.4	191.8	55.5%
1954	243.3	149.4	61.4
1955	341.4	232.8	68.2
1956	386.1	319.9	82.9
1957	442.2	374.0	84.6
1958	378.2	311.0	82.2
1959	303.8	210.7	69.4
1960	343.5	231.9	67.5
1961	316.1	196.8	62.3
1962	421.8	218.5	51.8
1963	560.3	232.6	41.5
1964	404.4	142.6	35.3
1965	463.4	135.5	29.2
1966	716.4	151.2	21.1

Source: United Nations; Yearbook of International Statistics, 1966, p. 452.

(2) South Korea has a much less favorable climate for agriculture than Taiwan. In addition, Taiwan's farmers had demonstrated a high responsiveness to changes in supply and demand conditions. They shifted quickly from less to more profitable crops.

(3) Other than the catalylic effects of U.S. aid, Taiwan's economic development was fostered by political stability, a skilled government administration, and policies that curbed inflation and

encouraged private enterprises. It was not until 1961 that the Republic of Korea was given a capable and stable leadership under General Park's revolutionary government. Without political stability, planned investment and the establishment of priorities will become impossible. The Republic of Korea launched its First Five-Year Development Plan in 1962.

Some macroeconomic indicators are presented in Table 18 for comparison. There were notable improvements in economic performance of both countries in the 1960's as compared with that in the 1950's. These improvements in economic performance were to a considerable extent the consequence of sizeable U.S. aid programs, coupled with major revision in policies. Major steps taken by the Chinese government are as previously mentioned. As for step taken by the Korean government, major revisions in its public policy include devaluation of the Korean Won in 1964, easing of import controls, the launching of a stabilization program, a firm commitment to the policy of fostering private enterprises, and the restoration of the normal relation with Japan.

Table 18
Comparison of Growth of GDP
in Taiwan and Korea

Average Annual Growth Rate (per cent)	Taiwan		Korea	
	1951-60	1960-66	1953-60	1960-66
Gross Domestic Product				
Total	7.8	10.0	5.0	7.6
Per Capita	4.1	6.7	2.7	4.7
Gross Domestic Capital Formation	12.9	14.7	8.3	20.7
Exports of Goods and Services	9.2	20.0	7.1	28.3
Imports of Goods and Services	8.9	12.3	1.0	12.5

Source: United Nations, Statistical Yearbook, 1967, pp. 569-70.

Therefore, it is concluded by Professor Ranis that: "what happened in both Taiwan and Korea was that once minimal security had been assured and markets activated as a result of a successful government stabilization and liberalization effort, the interplay of individual profit maximizing decision-makers could move the system forward, with foreign aid providing the buffer for additional import requirements and assuaging the fears of policy makers as to the "drain of resources" which might accompany such change. Once markets are activated and substantial new domestic resources come into play as domestic enterpreneurs begin to spend their efforts on productive tasks rather than on trying to outguess and outsmart the control system, foreign capital is likely to follow."[9]

Table 19
Trade Pattern of Taiwan: 1961-66
(in US$ million)

Trade with	Exports		Imports		Trade Balance
	Value	%	Value	%	
Developed Areas	1,320.7	61.5	2,140.0	82.6	-803.3
Less Developed Areas*	823.1	38.3	419.5	16.3	403.6
Unclassified	3.4	0.2	29.2	1.1	- 25.8
Total	2,147.2	100.0	2,572.7	100.0	-425.5

Source: IMF and IBRD, Direction of Trade.
Note: *Export trade with the Asian less developed countries amounted US$751.5 million which was 35.0 per cent of total exports.

Finally turning to the patterns of trade of both countries, Tables 19 and 20 indicate that both countries traded mainly with the developed areas. While Taiwan's trade balance recorded deficits in its trade with developed areas, the trade with less developed areas was in surplus. On the other hand, Korea's trade balances resulted in deficits for its trade both with developed areas as well as with less developed areas.

Needless to say, both countries had widened their trade connec-

9 Ranis, op. cit., p. 342.

tion when they succeeded in diversifying the commodity composition of their exports. However, the percentage composition of the exports to and the imports from the United States and Japan in total exports and total imports remained dominant as shown in Tables 21 and 22. The increase in the weight of exports to Viet-Nam was the overt effects of the hostilities in Viet-Nam. In addition, Taiwan and Korea are increasingly engaged in a processing trade with Japan which reflects the impacts of the hostilities in Viet-Nam on the Japanese economy. Thus a cessation of hostilities may raise problems of external as well as internal balances in Taiwan and Korea.

It is also worth while noticing that both countries succeeded in extending the process of import substitution to export promotion particularly for those highly standarized products, such as textiles (grey goods, cotton sheeting, and men's shirts), plywood, plastics and manufactures thereof, plate glass, cement, fertilizer, automobile tires and tubes, sports shoes, and wheat flour. These products do require neither expensive advertisement expenses nor any special adoptation to foreign tastes and conditions, hence tend to have easily accessible foreign markets and to sell largely on the basis of prices. Low labor costs have contributed to the successful

Table 21
Selected Country Percentage Composition
of Exports and Imports of Taiwan

Year	Exports to			Imports from	
	US	Japan	Viet-Nam	US	Japan
1961	22.4	28.9	5.5	40.7	31.0
1962	24.8	24.4	9.9	38.7	34.9
1963	16.5	32.1	9.7	42.3	30.1
1964	18.8	31.1	7.9	32.7	35.1
1965	22.0	31.1	9.8	32.1	40.2
1966	22.3	24.4	16.3	26.7	41.1
1961-66	20.9	28.7	12.5	34.2	36.4

Source: IMF and IBRD, op. cit.

Table 22
Selected Country Percentage Composition
of Exports and Imports of Korea

Year	Exports to			Imports from	
	US	Japan	Viet-Nam	US	Japan
1961	18.1	50.9	-	47.4	23.0
1962	21.9	42.8	-	52.3	25.9
1963	28.1	28.6	1.4	50.3	28.8
1964	29.8	32.0	5.3	50.0	27.2
1965	35.2	25.1	8.5	39.4	36.0
1966	38.4	26.3	5.6	35.4	41.0
1961-66	32.7	29.8	5.0	44.8	31.7

Source: IMF and IBRD, op. cit.

competition of the Taiwan and the Korean products with those of other exporting countries.[10] Converted at the official exchange rates, monthly earnings in manufacturing in the United States, Japan, Taiwan, and Korea in 1966 are presented in Table 23. Taiwan has been facing the competing exports in a wider range of commodities from Korea with even cheaper labor.

V. THE FUTURE

Taiwan and Korea have had remarkable success in their development efforts so far. Continued progress will require a continual expansion in exports. There are several reasons for this. First, through exports both countries will overcome whatever obstacles of domestic market size which limit their furhter growth. Second, it will be necessary to generate income-elastic supply of imports through expanded exports. Finally, by competing in the

10 R. Vernon, "International Investment and International Trade in the Product Cycle," Quarterly Journal of Economics, Vol. LXXX, No. 2, (May 1966), pp. 202-3.

Table 23
Monthly Earnings in Manufacturing in 1966
(in U.S. dollars)

Country	Monthly Earnings
The United States	$499.36
Japan	112.52
Taiwan	38.16
Korea	20.30

Source: United Nations, Statistical Yearbook, 1967, pp. 525-26.

world market, industries would be forced to attain and maintain high standards of efficiency and product quality. Trade would be the most effective antimonopoly policy, and the industrialists would gain considerable influence by virtue of being exporters.

Although the expansion of exports is an essential condition of sustained growth, it is not an easy task to develop a few lines of production with comparative advantage and high income elasticity so as to compete successfully with other countries in the world market. Opportunities based mainly on low labor costs will gradually be exhausted. Adequate export promotion policies have to pay a scrupulous regard for efficiency and standards and make vigorous market promotion. Successful export promotion also depends on the willingness of importing countries to purchase a growing volume of the commodities concerned which directly compete with their own industries. Some difficulties have already been encountered in exporting cotton textile products, rubber shoes, and canned mashroom and asparagus. Developed countries should buy more products from Taiwan and Korea, especially under the situation that the trade of both countries with developed areas has been in deficits as shown in Tables 19 and 20 above.

Although further industrialization will result in the setting up of new industries based on backward linkage, it is unlikely that Taiwan and Korea will individually be able to produce a variety of capital goods in view of the size of their economies. In this connection, it is imperative to find a framework for regional coordination of development plans and to reach what could be called "agreed specialization."[11] The industrial cooperation between Taiwan and Korea, though still at the initial stage, will certainly benefit both countries. An agreement in principle was reached to construct two petro-chemical plants to supply the demand for both countries, namely, Korea to provide caprolactum, and Taiwan DMT. To carry out the agreement will promote exports as well as the competitive capacity of both countries. Finally, Taiwan's small scale but successful technical assistance program in developing countries in South-East Asia, Africa, and Latin America has been not only a means of passing on Taiwan's own experiences, but also a promising way to widen its trade connection with less developed countries.

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11 S.B. Linder, Trade and Trade Policy for Development, (New York: Frederick A. Praeger, 1957), p. 130.

COMMENT ON KUO-SHU LIANG'S PAPER BY SOON CHOUGH

My comments on Professor Liang's paper are of two kinds: one is a small analytical matter, and the other is a supplement to Profes- Liang's discussion on comparison of the economy of Taiwan with that of Korea.

First, what I referred to as an analytical matter is his discussion on aid-generated local currency fund-what is generally known as counterpart fund. Professor Liang discusses the allocation of counterpart funds into various uses and his discussion reads as if the meant that they formed a part of foreign aid. How, U.S. aid undoubtedly has been a decisive factor in economic development of Taiwan - certainly this has been true for Korea. But in evaluating or measuring the impact of aid on economic development of aid recipient countries, I would tend to exclude the spillover effects of aid (such as industries or projects financed by the counterpart fund), to the extent that the real resources put into these projects are of the local origin. The important thing to consider is real resources rather than funds or money. The way in which these resources are mobilized can be profoundly affected, as they certainly have been, by foreign aid, but then capital created by domestic resources cannot be considered as aid as such, even though it may have been financed by counterpart funds.

Let me turn to the second part of my comments. Korea's economy experienced in 1968 another great leap forward - over 13% growth of real GNP. Aside from this figure - I do not want to engage in a number game - the Korean people are engaging in their development effort in a purposeful way. I quite agree with Professor Liang that Taiwan and Korea share the same pattern of development, and that the factors which gave rise to this kind of development are also similar- a relatively intelligent and energetic population, the existenc of infrastructure, U.S. economic aid, etc. I also agree with Professor Liang that Taiwan has so far been better situated than Korea in such matters as the relatively favorable agricultural climate of Taiwan which provided Taiwan with two important agricultural export items, namely, sugar and rice, and the fact that Taiwan was an earlier starter in her ascent forwards economic development.

But there seems to be one great difference between Taiwan's economy and Korea's economy at the present time. This is the fact that Taiwan has been able to achieve a kind of internal and external equilibria, while Korea has yet to achieve them. In Taiwan, inflation has all but been eliminated since 1963, but in Korea the rate of increase of consumer prices is about 10 % per year. It is also remarkable that Taiwan's unfavorable trade balance is very small, but Korea still has a sizable excess of imports over exports as is shown by Tables 19 and 20. Incidentally, both Korea's inflation and her great trade imbalance result from her development effort. However, Korea's experience in the past is a testimony that many difficult situations can be overcome, and I am not at all pessimistic about her future prospects in this regard.

My last comment is about the trade relations between Korea and advanced countries; I would like to join Professor Liang in urging the United States and Japan to buy more Korean and Taiwan products. Korea's imports from Japan in 1967 amounted to $US 443 million while Japanese imports from Korea were less than $US 85 million. A much less pronounced but similar disparity exists as regards trade between Korea and the United States. I would like to urge Japan and the United States to take as liberal a stand as possible in importing Korea's and Taiwan's products. Japan in particular has not only a comparative advantage in so many areas but also she has an absolute advantage in most industries, so that trade liberalization toward Korea would not bring about any dramatic change in the pattern of trade, at least for the next few years. Japan can afford trade liberalization torwards Korea and Taiwan.

COMMENT ON KUO-SHO LIANG'S PAPER BY ARTHUR PAUL

The report on the economies of Taiwan and of Korea that Prof. Liang has given us in this paper is indeed impressive. The factual information, which is well presented, speaks for itself, and there are no special comments on it that I want to add to those that he and Prof. Chough have already made. What is of more interest to me are several points in the paper that are related to the changing patterns of aid that apply to countries which have achieved self-sustaining economic growth. Economic aid, in the sense that it is ordinarily used, is no longer granted to Taiwan by the U.S., and this may soon be true of Korea as well. This does not mean that the U.S. interest in the economic development of these countries has ceased, but it does mean a different pattern of assistance, one in which investment and trade by private businesses, help from foundations and institutions and from some branches of the U.S. Government other than AID may play larger roles.

One aspect of the present stage of development in Taiwan is of special interest. The paper shows how important the development of some new processing businesses (canned mushrooms and canned asparagus) have been to Taiwan's economy. These are good examples of the application of modern technology to indigenous resources and to the use of indigenous skills to create new enterprises. This is related, of course, to the whole field of the transfer of technology, a field in which interest is rapidly increasing in Asia and in Western countries. There have been the dramatic examples of the success achieved in transferring Mexican wheat to India and in creating, by modern research methods, the new strains of rice at IRRI in the Philippines.

In this connection, it is interesting that one of the first non-AID assistance steps joined in by other U.S. organizations and branches of Government in respect to Taiwan was the sponsoring of a scientific seminar held there last spring at which the resources of the country were examined by local and visiting scientists with a view to identifying important areas for the transfer of technology. This is an indication of a trend of assistance for countries that no longer receive conventional economic aid.

A second point of great interest in Prof. Liang's paper is the reference to the first specific steps toward industrial integration with Korea, the agreement to construct two petrochemical plants to supply the demand for both countries. It is interesting that the ADB has been helpful in connection with these plans. What happens next will be watched with the greatest of interest by people who have been talking for years about regional integration and now have something concrete and specific to observe. Certainly these steps deserve outside support and encouragement.

There is one aspect of Taiwan's economy on which I would have liked to have seen some comment in Prof. Liang's report. I refer to the question of tax reform and the steps which the Government of Taiwan is now taking to tackle that matter. The efforts under way to improve financial and fiscal discipline and thereby to combat inflationary pressures are very important and deserve a place in a current description of Taiwan's economy.

Chapter 12

AID, TRADE AND ECONOMIC DEVELOPMENT: EXPERIENCE OF INDONESIA

Subroto

Introduction

Indonesia is today on the threshold of developing its economy, having almost completed rehabilitation and stabilisation measures, the first steps of which were taken in October 1966.

There are many factors determining the speed of development of an economy. Although these factors can be distinguished analytically, it is difficult to separate them, let alone to list them in their order of importance. It is also difficult to learn from comparisions with other countries, because of the differences in social institutions, the structures of their societies and their level of political stability.

Attempts to compare the rate of economic growth of developing countries appear to show that in most of the developing countries, economic growth depends crucially upon the extent of the availability of foreign exchange, from export or, in excess of the export based capacity to import, by foreign aid, to meet the increased demand for imports. The inter-relationship between trade gap, investment-savings gap and economic growth thus provide an important key to the assessment of past and future growth trends and prospect.

Investigations made by UNCTAD in fifty four developing countries from 1960 to 1965 showed that eighteen developing countries, which were able to increase their Gross Domestic Product by 6% or more, increased their exports by 8% or more. In contrast, fifteen developing countries which grow only by 4% or less, increased their exports only by 3% or less.

The study also indicated that developing countries with a 6% ore more growth rate, received foreign aid amounting to \$5.70 per capita. On the other hand, countries with a growth rate of 4% or less, received only \$2.10 per capita. Private capital is automatically attracted to developing countries with a high growth rate, while low growth rate developing countries received only \$0.23. The conclusion which can be drawn from the above mentioned study is that developing countries can grow sufficiently, if exports can be increased and enough foreign aid is received. If exports are stagnant and foreign aid is not received adequately, developing countries will only grow very slowly.

Another factor that is very strategic in the growth of developing countries, is the ability of these countries to increase their agricultural production substantially. For developing countries, the agricultural sector is the prime earner of foreign exchange and the source of foodstuffs. A decline in the production of the agricultural sector means less foreign exchange earned, resulting in a reduction of imports needed for investment. Inadequate production of foodstuffs means increased imports of food, at the cost of import of capital goods and raw materials for production.

The strategy that Indonesia is following for her First Five Year Development Plan, to be launched on the first of April 1969, put stress upon modernization of the agricultural sector and setting up agro-allied industries around this sector. All important foreign exchange is acquired through increased exports, foreign aid, private foreign investment and a rescheduling of debt.

This paper will consider the role of foreign aid during the period of economic rehabilitation and stabilization, covering the period of October 1966 to end 1968.

The Setting

Before starting to discuss rehabilitation and stabilization policy, it may be useful to present first some basic data about the Indonesian economy. Indonesia covers an area of 735,381 square miles, and as percentage of the total area, 1.4% is used for estate farming, while 13.10% is small-holder farming. Cultivation for foodcrops uses 9.30% of the total land area, and 3.80% of the total land area is used for cash crops.

Taken as a whole, Indonesia belongs to the group of Asian countries with a relatively low population density, with 157 persons per square mile in 1968, against 415 in India and 337 in Pakistan in the same year. The concentration of two-thirds of the population of Indonesia on two islands, Java and Madura, with only 7% of the land area, creates extreme density in the main population center. In 1968, the total population of Indonesia was estimated at 115 million, with a population growth of 2.5% per annum, increasing slightly over time. The relatively large numbers in the age-groups which are now approaching marriage age will probably cause a further rise of the birth rate, and combined with declining mortality, push up the population growth rate. It would not seem at all unrealistic to project an annual increase of population of around 3% by the middle of the seventies.

The Gross Domestic Product for 1968 is estimated by the World Bank Report at RP 2,920 billion. Real rate of growth from 1961 to 1967 has been 2% per annum, but to 1968 the rate of growth is estimated at 4%. The per capita GDP in 1968 is estimated at $83.00. In percentage terms, agriculture contributed 47% to the Net Domestic Product at factor cost for 1967, while for manufacturing and trade it was 28%. Public administration's share in the NDP was 5%, mining 3%, for other sectors, 17%.

Gross savings is estimated as 3.1% of the Gross Demostic Product at Market Prices in 1968, while the gross investment is at the level of 6% of GDP.

Exports depend heavily on two commodities, rubber and oil, and commodity concentration of these two commodities is 51% for 1968.

Prior to 1967, Indonesia was borrowing abroad large amounts on unfavorable terms for undertakings, most of which were of very low or negative productivity. This resulted in a very heavy accumulation of debt service payments through the 1970's. The debt ratio in the 1970's will probably be around 30% of export earnings on any reasonable assumptions regarding future gross capital inflows and export growth.

In 1967, Indonesia received aid from donor countries, known as Inter-governmental Group for Indonesia, totalling $US 200 million in the form of commodity aid. In 1968, the amount of aid has been increased to $US325 million for commodity aid and project aid. In addition, the United States later in the year agreed to provide a substantial additional amount of wheat, in conjunction with other countries, to meet the very clear emergency situation, that had arisen with respect to shortage of rice.

As to the terms of aid received in 1967 and 1968, they correspond to the DAC terms, namely repayment 20-25 years, with a period of 7 to 10 years grace, and interest rates not higher than 3% a year. For food aid the terms are softer, with up to 40 years repayment, 2% interest during a 10 year grace period, with $2\frac{1}{2}$ %

interest during the period after the grace period.

The Economic Situation from 1959 to 1966.

When President Suharto came into power in July 1966, he inherited from the previous regime a mis-managed and deteriorating economy. A look at the cost of living index of Djakarta, gives an idea of the state of the economy.

Table 1

Cost of Living Index in Djakarta, 1959-1966.
(1957 = 100)

End of Year	Index	% of Increase
1959	166.0	19.4
1960	215.0	29.5
1961	380.0	76.7
1962	976.0	156.8
1963	2,226.0	128.1
1964	5,234.0	135.1
1965	36,347.0	594.4
1966	267,279.0	635.4

Source: Central Bureau of Statistics

The movement of prices since 1960 marked Indonesia as a textbook case of a hyper-inflation in a less developed economy. The hyper-inflation resulted from an increasingly severe shortage of most essential domestically produced and imported consumer goods, accompanied by a rapid expansion of money supply.

Government rice policy was a major factor generating the inflation. Although the price control system was liberalized in 1963, the government continued to purchase domestic rice at market prices through the Rice Purchasing Board (BPUP). In 1964 the purchase program was enlarged to include corn and tapioca. However, the imposition of price controls in April, 1964 on a number of necessities, together with rather inefficient government procurement practices, contributed to a continuous dependence of rice deficit urban areas on imported rice. Between 1961 and 1964, rice imports fluctuated around 0.96 million and 1.07 million of tons.

Under these conditions the Government decision in August 1964 not to sign any new contracts for the import of rice, was an important factor generating a sharp inflationary stimulus. In 1965 rice imports amounted to only 190,000 tons, less than 20% of the previous year's imports.

The inflationary pressures were fed by continuous and sharply rising budget defict, generally financed with new money.

Table 2

Central Government Finance, 1959-1966.
(in millions of repiahs)

Year	Gross Revenue	Gross Expenditure	Deficit
1959	30	44	-14
1960	50	58	- 8
1961	62	88	-26
1962	74	122	-48
1963	162	330	-126
1964	283	681	-398
1965	923	2,526	-1,603
1966	13,680	29,010	-15,330

Source: Central Bureau of Statistics.

Government fiscal operations have resulted in budget deficits continuously since 1952. Commencing in 1964, the cash deficit even exceeded total revenue. In 1965, it amounted to 156% of total revenue, compared with 125% in 1964 and 18% in 1960. In real terms (i.e. deflated by cost of living index for Djakarta) expenditures and receipts were 27% and 69% respectively lower in 1965 than in 1960. During the same period, 1960-1965, the ratio of government expenditures to national income (at constant prices) declined almost from 15% to 10%, while the ratio of government revenue to national income fell even more sharply from approximately 13% to only 3.6%.

As in previous years, the cash deficit in 1965 was financed by resort to central bank credit. The sharp rise in expenditures was attributable mainly to the increase in civilian and military salaries, including rice allowance, the price of which rose by as much as 660% during the year, as well as to the higher cost of domestic and imported goods procured by the Government and the further rise in military outlays in connection with the policy of Confrontation. Thus, expenditures on the security sector and related special expenditures increased from 40% of total expenditure in 1964 to 49% in 1965, while expenditures on the economic sector declined from 49% to about 42%.

The rate of increase in money supply accelerated during 1965 and the first half of 1966. The cumulative rise was 626% between December 1965 and December 1966.

Table 3

Money Supply and Its Percentage Change
(in million of rupiahs)

Year	Total Money Supply	% Increase
1959	35	19
1960	49	37
1961	68	41
1962	136	100
1963	263	93
1964	675	157
1965	2,688	297
1966	19,510	626

Source: Central Bank.

The sharp expansion of money supply in 1965 and 1966 was mainly for financing the rising budget deficit. It was also caused by the extension of bank credit to state enterprises and the private sector. Currency in circulation was the main vehicle of monetary expansion, while demand deposits showed a smaller total increase over the period.

A currency reform launched in December 1965, which introduced a new rupiah equivalent to 1,000 old rupiahs, was not successful in stemming the rise in money supply.

As could be expected during the period of acceleration of inflation, since 1960 real cash balances (i.e. the money supply index deflated by consumer price index) followed in general a downward trend. At the end of 1966, they were equal to only one third of their 1960 value. This was to a large extent a reflection of sharply increasing prices, which caused money to cease to serve as an acceptable store of value, even in the short run; and hence, led to an increase in the velocity of circulation. The velocity of money almost doubled between 1961 and 1965.

The Rehabilitation and Stabilization Program Since October 1966.

Recognizing that development of the economy will be hard to carry out as long as the country is still suffering from inflation, the Government has adopted stabilization measures, which are chiefly aimed at eliminating the cause of inflation in all sectors. The principle elements of the country's stabilization program have been launched in three waves.

The first wave was introduced on October 3, 1966 and some of the more important measures are briefly described below.

In the fiscal field, the Suharto Government has issued instructions aimed at augmenting government revenue through intensification of tax collections and an austerity drive in respect of government expenditures. Under the tax intensification program, the Minister of Finance has been asked to chalk out an immediate course of action, to collect all overdue taxes and set up a new system to facilitate future tax collection. He also has been authorized to recruit the necessary additional personnel for tax collection, and other government departments, including the Armed Forces, have been directed to lend the services of their personnel, to assist in tax collection when necessary.

The instruction relating to the austerity measures contains some basic as well as detailed directives. Under the basic directives, each government department is instructed to practice maximum possible economy without hindering the efficiency of its operations. All new purchases have to be based solely on the urgency of carrying out the main tasks of each government department.

The detailed directives call for, *inter alia*, maximum economies in foreign travel expenditures by government officials on state business and strict screening of all such travel plans; prohibition against spending government money for parties, celebrations; the refund of unutilized appropriations by all departments at the end of each year to the Treasury.

On monetary measures, instructions have been issued, aimed at the tightening of credit control generally and at insuring that the bulk of new bank credits (about 90%) would go hereafter only to finance exports and various productive sectors of the economy. The principal features of the new credit control regulations were among others:

a. In granting credits, all the banks have been instructed to observe no discrimination whatsoever as between state and private enterprises. In particular, banks have been prohibited from extending the so-called "command credits" to state enterprises, which were previously extended without regard to the purpose or the credit worthiness of state enterprises.

b. No credit may be extended without specific agreement between participants. The banks have been instructed to limit their credit only for the financing of most urgent expenditures of enterprises. Expressly forbidden are long term credit (exceeding 3 years) and credits for financing of taxes to the government. The banks are requested to refrain from extending overdraft facilities on current account or loans in excess of credit ceilings fixed in the contract.

c. Import credit can only be granted in some urgent cases related to production. Provisions have been made to require importers to make advance deposits against imports and other import charges, as well as an advance payment of 50% of duties, due at the time of submitting an import declaration.

d. Export credit cannot exceed 40% of the value of export contract. Furthermore, credit can only be granted to those exporters who provide proof of actual physical possession of goods to be exported and of the export exchange contract already contracted with the buyer abroad.

e. The directives of 3rd October also included revisions of the bank's interest rate structure. Commercial banks were instructed to charge 6% per month interest for credit extended for food production, $7\frac{1}{2}$% for export and textile production, and for all other credits, including credits for the trade and distribution sectors, 9% per month. Overdue credits bear a penalty rate that is 50% higher than the normal interest rate.

The new pricing policy of the October regulations aimed at gradual elimination of government subsidies of the state enterprises, and the resulting price distortions. The government instructions provide for the possibilities of smoothing out internal price adjustments. Subsidies may also be granted if necessary, to certain categories of the most essential imported goods and materials, such as rice, fertilizers, newsprint, medicine and textbooks. Price control of domestic products and services was limited to petroleum products, electric power, city transportation and drinking water.

According to the instruction, market forces should determine the prices of the goods and services sold by the state enterprises, not subject to price control. The ministries concerned were instructed to coordinate and supervise this process of transition towards market economy in the state sector.

Liberalization of the foreign trade sector through the introduction of the Bonus Export System was also initiated in October 1966. The B.E. System was adopted in order to simplify the exchange rate structure, which enabled a free trade in foreign exchange earnings from exports in the open market. The floating exchange rate, as a part of this system, makes it possible to maintain a true exchange rate between the rupiah and the foreign currency. The B.E. System relies on the operation of the market forces in the allocation of foreign exchange, thus abolishing the old practice of foreign exchange allocation by the government. The method is also aimed at removing one of ten main sources of illegal manipulation and corruption.

With respect to import policies, the initially narrow Bonus Export-Import list has been broadened, to enable more widespread imports of essential commodities. In essence, Indonesia is moving towards a single fluctuating exchange rate for most import transactions and greater reliance on free market forces to determine import priorities.

On the export side, the Bonus Export System is meant to give greater incentive to exporters, by giving more share of foreign exchange retained, by providing automatic foreign exchange allocations to the provinces, and by awarding premiums for exports in excess of annual targets as incentive for the regions. To encourage exports, the government also simplified administrative procedures and reduced its direct involvement in foreign trade.

To October measures also laid down rules for contracting and use of foreign credits. The amounts of credit outstanding at any one time for the import of general commodities (not capital goods), whether received by government or by private enterpreneurs or by banks (acceptance credits) must not exceed $US60 million in value or 180 days in duration, except in the case of government to government credit, which must be for not less than five years. Credits for projects (capital goods) can be accepted only from foreign government or semi-governmental bodies, or an international organization, and only if the grace period for such credit is at least five years. Short term and medium term credits must not be accepted. For supervising the implementation of guide lines for contracting or use of foreign credits, a Ministerial Committee and Technical Committee were established. All government agencies were directed to indicate to the Technical Committee any foreign credit offers from any source, private or governmental. All government departments and regional authorities were forbidden from concluding foreign credits prior to the consent of the Committee. Foreign credit offers received by branches of the Armed Forces are also subject to the requirements mentioned above.

In January 1967, the Indonesian Government promulgated a Foreign Capital Investment Law, welcoming full participation of foreign capital in all economic activities, except in public utilities, atomic energy development, defense production and other fields to be stipulated by the government on an *ad hoc* basis. Among others, the new law offers liberal exemptions or deductions from various taxes and other levies for a stipulated period of years. It also guarantees liberal facilities for remittance of profit after deducting taxes and other financial obligations in Indonesia. Further, the law permits the employment of foreign workers and gives the owners of foreign capital full authority in appointing the managers of their enterprises in Indonesia. A guarantee against wholesale nationalization is provided for and stipulates equitable and mutually satisfactory arrangements in any specific case. The law welcomes the formation of joint ventures and requires foreign capital to provide suitable oppotunities for active participation by domestic capital, in some proportion, and after a period, to be determined by the government. Partly to supplement the adoption of the Foreign Investment Law and partly to facilitate the full utilization of the productive capacities of various former foreign-owned estates and other enterprises now under government control, negotiations were opened to return them to the foreign owners.

Since Indonesia was unable to service her debts, because of the serious shortage of foreign exchange, the Indonesian government entered into negotiations with her credit countries, to obtain rescheduling of the debt repayment. This request led to multilateral negotiations with creditor countries in Tokyo and Paris. Bilateral negotiations were held with Yugoslavia, the USSR and other East European countries. Meetings with interested donor countries were also held to discuss the prospect of aid, to alleviate balance of payments difficulty and to support its most essential import needs.

The second wave of stabilization measures was launched in February 1967, when price adjustments on wider scale were executed. Prices and service rates of state enterprises were adjusted to the free market level on a cost accounting basis. In the past, prices of commodities produced and services offered by state enterprises were artificially determined by the government at unrealistically low levels, thus forcing the State Treasury to make up for the losses incurred, by paying substantial amounts of subsidy. The new measures not only discontinued subsidies to many of the state enterprises, and thus released the Treasury from bearing a heavy burden but allowed state enterprises to operate more economically and compete on an equal footing with private enterprises, by charging realistic prices.

The third wave of stabilization measures came in July 1967. Export taxes were reduced, and export procedures were further simplified. Non traditional export products received more incentive through larger overprices. Steps were taken to improve road transportation and harbor facilities and to improve the efficiency of shipping, which are essential requirements for export expansion and domestic distribution. While efforts are being made to curb inflation, salaries of government officials were raised in an attempt to increase their standard of living and their efficiency.

Results of the Stabilization Measures.

Since the basic aim of the government with the stabilization measures is to control inflation, it seems quite natural to use the rate of inflation as the basic criteria to evaluate the results of the policy. For the whole year 1968, the inflation rate is 84.8% as compared to 171.05 for 1967. For the last 6 months in 1968, the period since the Development Cabinet comes into power, the monthly inflation rate is only 2.6%. Clearly, the all important battle against inflation is showing some success. The crisis that was triggered toward the end of 1967 and the early months of 1968 from shortage of food and sharp depreciation of the rupiah, was overcome by swift imports of expensive rice, intervention in the exchange market and

Table 4

Consumer Price Index for Djakarta
(September 1966 = 100)

Year		General Index	Monthly Change	Yearly Change
1966		76	----	----
1967		206		171.05
	January	145	9.02	
	February	174	20.00	
	March	180	3.45	
	April	181	0.56	
	May	181	0.	
	June	187	3.31	
	July	191	2.14	
	August	201	5.24	
	September	222	10.45	
	October	238	7.21	
	November	287	20.59	
	December	283	-1.39	
1968				84.8
	January	395	39.58	
	February	432	9.37	
	March	445	3.01	
	April	419	-5.84	
	May	444	5.97	
	June	455	2.47	
	July	475	4.40	
	August	492	3.58	
	September	493	0.20	
	October	487	-1.22	
	November	505	3.70	
	December	523	3.56	

Source: Central Bureau of Statistics.

sharp curtailments in the planned routine budget expenditures for government personnel. The upward surge of prices could finally be checked, thanks to satisfactory increases in rice production and well timed arrival of food aid shipments. These steps, combined with carefully planned fiscal and monetary policies, have contributed in a very high degree to the favorable price movements. The stabilization policy initiated toward the end of 1966 has finally caught hold.

Thanks to the stable prices of basic commodities during 1968 and relatively favorable world market prices for the export commodities, export, including oil, increased by 14.9% to $US881 million, as compared to 1967. This satisfactory increase in exports is primarily caused by a 20% increase of exports of oil and oil products.

For the year 1968, the budget is in balance at RP 183 billion, which is a major achievement. The improvement in the budget during the second half of the year has been achieved primarily by increasing government revenues, which resulted from a sharp rise in revenue from income and corporation taxes, because of improved collection.

While there is reason to hope that the Indonesian economy is now set on a steadier course than it has followed for many years, its management will continue to demand the unremitting efforts of the entire administration. In particular, the gradual transition from preoccupation with stabilization objectives to the pursuit of economic growth, will call for dexterity in timing, flexibility in decision making, and courage in executing decisions. Any due haste in moving away from cautious financial policies may upset the confidence which is slowly returning and yet any unnecessary delay in meeting the legitimate financial needs of domestic industry and agriculture can only slow down the recovery of domestic production. In the meantime, balance of payments support clearly remains a critical element in the success of Indonesia's efforts to restore itself.

External Assistance, 1966 to 1969.

Although the success of the stabilization policy can be explained by the untiring effort of the Indonesian government under the leadership of President Suharto, foreign aid has played a very important role in speeding up the stabilization of the economy. During 1966, Indonesia received emergency financial assistance to support its most essential import needs and to alleviate its balance of payments difficulties. Financial assistance authorized during 1966 amounted to $US133 million, of which $US15 million was in the form of grants and the remaining $US118 consisted of commodity loans. The interest charges on the loans varied from country to country. The United States charged 2½% to 3½%; the Netherlands and Germany 3%;

and India and Japan and Pakistan, 5½%.

In addition to the amount mentioned France authorized project credits amounting to $US19.5 million; the Netherlands authorized export credits of $US7 million and Japan provided credits of $US 14.1 million in connection with certain production sharing arrangements.

At the invitation of the Netherlands Government, an Inter-Governmental Group met in Amsterdam in February 1967, to exchange views of the possibility of assisting Indonesia's effort in implementing stablization and rehabilitation programs in 1967.

Following the discussion of the Indonesian policy for combating inflation, improving production and strengthening the country's balance of payments, the Group estimated the foreign exchange gap for 1967 in the rough order of magnitude of $US200 million and that the estimated gap would need to be met by credits, loan and grant agreements.

With regard to the mechanism of aid, the Group stated its willingness to channel aid through the Bonus Export market mechanism. This procedure assured the fullest possible integration of aid into the present import regime.

As regards the question of terms of assistance, which was closely related to the burden of indebtedness, it was generally recognized that Indonesia's debt situation was very serious. It was agreed that donor countries, subject to limitations of practicability and legislative authorization, would take into account the desirability of extending as much new assistance as possible in the form of grants and soft loans. The element of softness would apply particularly to grace periods, due to the fact that projections show that repayment obligations will be particularly very heavy during the 1970's. Softness relates also to interest rates, in view of the recognition that Indonesia should have an opportunity in the long run to start reducing the level of its indebtedness.

The Indonesian Government has requested commodity loans for 1968 to the amount of $US250 million and $US75 million for project loans in disbursement terms. It is gratifying to note that in the course of 1968, new commitments for commodity aid and PL 480 aid and PL 480 aid has reached $US254 million while additional food aid has been made available to the amount of $US58 million. Thus, non-project assistance has reached a committed level of $US304 million. Taking into account the amount of carry over from 1967 of $US26 million and an estimated pipeline into 1969 of $US32 million, the toal utilization of program aid for 1968 is $US298 million.

Apart from the export earnings and the net foreign exchange contribution of the oil sector, this amount of foreign assistance must be appraised as the crucial additional source, which has made possible a commodity supply, and contributed greatly to the improved stability of the economy in 1968.

However, one important development in the balance of payments in 1968 must not be overlooked, namely that it ended up with a net increase of short term indebtedness of almost $US50 million. This fact is the more important since the debt incurred has been used to import rice and fertilizer. It thus becomes clear that the achievement of stabilization of the economy in 1968 was possible not only through utilizing program assistance of $US298 million, but also by a net increase of short term liabilities by $US50 million.

The emphasis on growth, in conjunction with further price stability during the year 1969 calls for adequate and timely program aid. Bearing in mind the amount of carry over from 1968 of approximately $US32 million and about equal pipeline into 1970, the Indonesian Government has put its requirements and requests for a new program aid at $US320 million for the calendar year 1969.

Total import requirements are estimated to reach $US850 million for the non-oil sector, or about 1.8% higher than 1968. Non-oil export is estimated to increase by approximately 6.5% in 1969. On the other hand, service payments will increase by about $US13 million, resulting in a current deficit of $US340 million in the oil sector.

As for project assistance, Indonesia has submitted a requirement of $US180 million. This amount is based on a commitment basis and not on a disbursement basis, as was the case for 1968. In entering the rehabilitation and development phase it is obvious that project assistance must play a more important role.

The Problem of Debt Burden and the Terms of Aid.

The problem of debt servicing will form a heavy burden for Indonesia in the 1970's. According to the study made by IMF, which has made several projections, the debt-service ratios in the seventies will exceed 20%. Assuming certain amounts of gross capital inflow on DAC terms, debt-service ratio in the seventies would rise as high as 40%, according to the study made by the World Bank.

In order not to neutralize the benefit of economic growth which will be achieved during the coming years by virtue of the implementation of the Five Year Development Plan, better conditions and terms for aid for Indonesia has to be extended. It was considered that countries not yet offering DAC average terms should try to do so as early as possible and that other countries should investigate the possibilities of improving terms of aid, where possible.

During the debt rescheduling conference of Indonesia's creditors, held in Paris in October of 1968, the conference had decided that besides a rescheduling of the 1969 debts, that a study be made of Indonesia's balance of payments prospects and of the problems caused by the debt burden.

COMMENT ON SUBROTO'S PAPER BY H. W. ARNDT

Professor Subroto should be congratulated on a clear and concise account of the stabilization of the Indonesian economy during the past two years. What he and his economist colleagues have achieved in the two years of the Suharto regime is remarkable. After years of gross mismanagement, Indonesia has at last a government which gives priority to the country's appalling economic problems and tackles them energetically and sensibly. But he would be the first to agree that only the first steps towards recovery have been taken.

Even on a short-run view the achievements are still only partial. The relative price stability achieved in 1968 was greatly aided by the luck of a good rice harvest; money supply is still rising rapidly and it remains to be seen whether stability can be maintained. The balance of payments is still heavily in deficit, dependent on external support. Industry is still operating well below capacity; industrial and infrastructure capital is probably still deteriorating (i.e. improvements here and there as yet do not match disinvestment elsewhere). Disguised unemployment includes 3 million civilian and 0.7 million military government employees; paid absurdly low salaries, they are virtually forced into 'job inflation' and corruption; yet large-scale dismissals are politically impossible and adequate salary increases would completely disrupt the budget. Rehabilitation of export industries (except oil) is slow, almost imperceptible, while foreign investment is unlikely to make much impact for another 2-3 years.

The long-run prospects are overshadowed by population growth on Java, adding every year 2-3 millions needing food and jobs. The outlook for food production to which great efforts are being devoted is relatively promising. But the employment problem is threatening to become overwhelming. In the short run rehabilitation of existing industry and perhaps labour-intensive new agricultural technology offer the best hope of relief. In the long run, industrialization is essential but is unlikely to match the growth of the workforce for years to come. Above all, the country still lacks most of the basic requirements of economic development, administrative, managerial, professional, entrepreneurial skills and attitudes. Yet, unless effective economic development gets under way, one cannot be optimistic about continued political stability.

How can the developed countries help Indonesia?

Trade liberalisation has very little to offer Indonesia at this stage. Preferences to exports, the problem is production rather than markets. What Indonesia needs is aid on an enormous scale, in four main forms: (a) continuing balance of payments support, probably for at least another five years; (b) bilateral and multilateral project aid for infrastructure and industrial projects (preferably on a "turn-key" basis); (c) private direct investment for the development of mineral and other natural resources and industry and (d) perhaps debt remission. There is also need for technical assistance, although absorptive capacity for training abroad and experts is limited; in any case technical assistance can develop skills but not the even more important attitudes.

The problem of Indonesia dwarfs all other economic problem of SE Asia. Compared with the contribution the advanced countries could make to human welfare here, the contribution of PAFTA would seem trifling.

COMMENT ON SUBROTO'S PAPER BY MASARU FUKUDA

The author presents a very lucid picture of the remarkable achievements the new Suharto regime has made to arrest the inflationary trends in Indonesian economy. I feel particularly the merit of the presentation derives from the fact that the author has written with the eyes and minds of Indonesian people because he happens to be one of them. Not only that, the author has the superb talent of covering only the essential aspects of major policies in a comprehensive way leaving the inessentials untouched. This compliment is my frank feeling in the light of many excellent reports, Asian Development Bank staff papers, and mission reports which I have naturally had opportunities to read--in other words, the author's presentation produced a unique and lucid picture, the product of a deep understanding of the situation, which is possible perhaps only in an Indonesian heart and mind.

The important point in my mind is the transition from stabilization towards rehabilitation of production and expansion--the author writes about this crucial problem in an excellent few lines, brief but so superbly well described, to wit, "Any due haste in moving away from cautious financial policies may upset the confidence which is slowly returning and yet any unnecessary delay in meeting the legitimate financial needs of domestic industry and agriculture can only slow down the recovery of domestic production."

In this regard, as the author writes, "In the meantime, balance of payments support clearly remains a critical element in the success of Indonesia's efforts to restore itself." Substantial external aid from the Indonesia Club arranged by AID for 1966, 1967, and 1968, has made a significant contribution. The problem is the respective outlook in the immediate future. How long will balance of payment support on this substantial scale by external AID recruitment go on? Much will depend on the determination and spirit on the part of the people of Indonesia to make Indonesia a new self-supporting economy. It would appear to me unreasonable to be optimistic, particularly in view of the tremendous natural resources with which Indonesia is blessed. Hope must be given in the minds of the people so that they will tread the difficult path towards the light at the end of the tunnel which might not yet even be seen, but might suddenly reveal itself if the people continue their sound efforts at self-help.

Chapter 13

ECONOMIC DEVELOPMENT AND REGIONAL CO-OPERATION IN SOUTHEAST ASIA

Hiroshi KITAMURA[1]

I. The rationale of economic regionalism

Economic regionalism appears today as one of the major goals of economic policy in the countries of Southeast Asia. The growing emphasis being given to the concept of regional co-operation and integration implies the belief that more efficient solutions to some of the economic problems in this area can be found through a regional approach rather than through approaches on a national or global scale. This belief in the efficiency, and even the necessity, of such a regional approach is closely related to the recent world trends, partly of economic policy, partly of technology, and partly of historical and political developments of the human society.

There is a consensus of views that any solution to the important economic problems of the contemporary world, be it in the field of trade and development or international monetary crises, involves continuous negotiation among governments and reconciliation of divergent interests and points of view. We have travelled a long way, indeed, from the world in which solutions could be entrusted to the "invisible hand". Corresponding to the broadening of horizons of the economic policy of states, the basic tasks have now to be performed by negotiated rather than spontaneous policy harmonization among independent governments. But there are reasons for assuming that success in these efforts is more likely to be reached by regional, rather than by universal, organizations and institutions. The difficulties involved in world-wide negotiation have been amply brought out by the recent experience of UNCTAD; the depth and comprehensiveness of feasible co-operation and commitments are generally in inverse relation to the number and heterogeneity of the participants. Obviously, the regional approach provides greater potentialities than the global one for more intimate forms of integration and harmonization of policies among a limited

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1 The author is Director of Research and Planning, United Nations Economic Commission for Asia and the Far East. The paper expresses the personal views of the author and does not necessarily reflect those of the ECAFE secretariat.

number of countries highly interdependent, keenly conscious of this interdependence, and relatively well prepared for such co-ordinated action by geographical proximity, a common historical and cultural background, and a relatively homogeneous stage of economic development.

It is not only public economic policy which requires a regional outlook for effective implementation; the business decision-makers in the private sector have also increasingly become conscious of the necessity to plan for a larger regional market. The voices of the leaders of the Southeast Asia business community are even louder than those of the government leaders in demanding "regional planning".[1] Basically, the trend towards regionalism is due to the fact that recent technological changes have greatly broadened the scope of economies of scale, creating a need for a large and stable market, larger than a national one. Regardless of the extent to which we accept the basic tenet of the materialistic interpretation of history, there is no denying that changes in economic and social institutions are often conditioned by the evolution of technology. In this sense, indeed, "regional arrangements are no longer a matter of choice. They are imposed by the requirements of technology, science and economies"[2] of the contemporary world.

In a broader context, regionalism is a necessary phase of historical evolution; it is a pattern of thinking and action that is deeply rooted in the transition from nationalism to universalism. Economists of the Neo-Historical School in Germany used to see the successive stages of economic development as a movement, starting from economies of villages and cities, to ever larger units, namely to territorial and national economies, and from there to a world economy. What they may have failed to see, however, is that there is bound to be an intermediate phase of regional institutions between nation states and world organization. It was the "Zollverein" of the nineteenth century that brought various cities, counties and dukedoms in Central Europe together into the nation

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1 "Regional planning" was the leitmotiv adopted for the Singapore meeting of the Southeast Asia Business Committee sponsored by the Stanford Research Institute International, 13-15 May, 1968.

2 Foreign Economic Policy for the Twentieth Century, Report of the Rockefeller Brothers Fund, Special Studies Project Report III, New York 1958, p.30.

state of Germany. It is no accident that the same word, "customs union" in English, is now being used to define one of the institutional forms of regional integration; the contemporary trend towards regionalism is nothing but a continuation of the historical movement connected with the formation of modern nation states. Now, nation states themselves are gradually being merged into larger economic, and even political, units under the dictate of modern technology which requires a certain minimum scale of market and production as an efficiency criterion.

The significance of this progress towards regionalism is likely to be obscured to contemporary observers by its being so gradual. In Asia, in particular, where national independence is generally of a recent data, emphasis still continues to be placed on the constructive role that nationalism can play in promoting economic and social development; there is a legitimate scope for national identify to form a consolidated basis for development. And the growing recognition of the need for regional co-operation tends to be subject to the dominant considerations of national sovereignty. But maturing nationalism in many countries is increasingly capable of recognizing that enlightened self-interest demands that they look beyond national boundaries, and a slowly emerging sense of regional identity is being superimposed on the national consciousness. The two decades since the end of the Second World War have, in fact, brought about decisive changes in this respect: while Asia in the immediate post-war period could still be characterized as a conglomeration of territories without the unifying idea of a region, today no leader of a Southeast Asian nation can be indifferent to what happens in the neighbouring countries. The Association of South East Asian Nations (ASEAN) is a living symbol of the growing sense of regional identity. It is increasingly recognized that economic interdependence is bound to become a reality in this region, too, or more important, that economic interdependence must become an imperative goal if the economic growth of the region is to be accelerated.

The last viewpoint is important, because the objective of economic growth adds a new dimension to the problem of economic regionalism in Southeast Asia. When the discussion turns around the benefits of regional co-operation in this region, it is mainly related to economic co-operation or integration among developing countries of Southeast Asia, that is, among countries at similar levels of economic development. This implies that inter-sectoral or intra-sectoral specialization should be organized on the basis of a similar pattern of factor endowment. It will readily be recognized that this type of horizontal specialization is fundamentally different from the classic pattern of international division of labour between primary producers and manufacturers. In terms of economic theory, it means that the technological factors of economies of scale have to take precedence over the factors of differential natural endowment as the explanatory principle of the pattern of specialization. This interpretation also affords much greater scope for mutual negotiation and agreement on specialization than for the market mechanism of free trade to determine the most desirable pattern of international division of labour. The need for re-interpreting the trade pattern arises from the observation that a recent trend in world trade is for trade relations between countries at similar levels of economic development to grow at the expense of interchanges between developed and developing countries.

The tendency of exports from the developing countries to the developed countries to lag considerably behind export trade among the developed countries has created enormous problems for the developing countries of the present day. As a long-time student of international trade, I am deeply impressed by the difficulties the developing countries are now facing in trying to develop on the basis of their traditional primary exports. Nor, unless there is a radical change in the trade policy of developed countries, are prospects bright for a considerable expansion of extra-regional exports of goods other than the traditional export commodities. The only solution remaining is for the developing countries to aim at diversified output expansion for home markets by substituting domestic production for as many lines of imports as possible. But, insofar as import substitution is organized on a limited national scale, this cannot be a desirable solution; unless accompanied by a sufficient increase in productivity, a persistent substitution policy may impair efficiency and entail a reduction of exports. For certain lines of manufacturing activity, the home markets of many developing countries in Asia may be far too narrow to support the minimum size of plant needed for efficiency. The only way out, therefore, is to conceive the policy of import substitution on a broader and more rational basis. In economic terms, this is the essential contribution that regionalism can make to the goal of economic development. In short, regional economic integration provides the only framework in which economic development can be accelerated on the basis of an import-substitution policy without detriment to the efficiency and advantages of specialization in production.

II. Operational approaches to Southeast Asia integration

The Association of South-East Asian Nations (ASEAN), to which reference was made earlier, is a unique body among a number of international organizations that exist today in the region with the objective of achieving some degree of economic co-operation on a limited regional scale, such as the Asian and Pacific Council (ASPAC) and the Ministerial Conference for Economic Development of Southeast Asia. It is unique in the sense that it is composed of the developing countries in the compact sub-region only, being formed on their own initiative, and has thus achieved a vary high degree of homegeneity in political and economic outlook. Soon, a population of 200 million and gross product of $25 billion will easily provide a market large enough to support a highly diversified and efficient economic structure on the basis of the rich variety of resources available within the area. As it is constituted at present, therefore, ASEAN appears to be relatively of great potential to develop into a viable economic grouping, reflecting the aspirations and the capacity to act collectively of the member countries. There are, of course, several political clouds darkening the horizon in the short run, but recent experience shows that these frictions might even prove the possibility of "long-term, supra-national economic considerations taking precedence over short-term political interests".[4]

Despite all the favourable prospects for collective decisions and actions, however, the achievements of ASEAN so far appear to have been rather limited. It is understandable that in a young institution greater emphasis has to be placed on preparatory studies rather than on the execution of projects. But a cursory examination of the list of projects selected for implementation or study suggests that preference has been given to subjects of technical or research co-operation, such as exchange of information and experts, or activities relating to international traffic that do not involve any economic policy issues, such as tourism, transport, communications and visa practices. Even the problems of food production and supply have mainly been approached in terms of exchange of information and research co-operation. In contrast, there has been an apparent reluctance to take up for discussion problems in which the consideration of economic policy as such would inevitably be involved.

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4 Far Eastern Economic Review, Vol. LXII, No.52, 26 December 1968, p.711. The reference is to the diplomatic talks at the Thai resort of Bang Saen during the second weekend of December 1968.

The notable exception has been the project of trade liberalization, but it is not yet known how the recent Manila conference of representatives of ministries of commerce and industry defined the approach to the policy issues involved. At this juncture it is worth noting that the possibility and implications of a limited free trade area have been selected by the ASEAN Standing Committee for further study. If taken up seriously, the study may possibly mark the beginning of an attempt to co-ordinate policy within the ASEAN framework.

With that exception, it is fair to observe that, while subscribing to the ideal of regional co-operation, the ASEAN countries appear at the present juncture extremely hesitant to undertake anything more than technical co-operation. Countries in the region are still too sensitive about any scheme of commitments that might touch upon national sovereignty to the slightest degree. Serious co-operation in terms of economic policy --co-ordination or harmonization of economic policy as a whole--is therefore looked upon with incomparably greater suspicion than technical co-operation with regard to isolated projects.

This limited frame for co-operation is also reflected in the institutional arrangements which are characteristic of ASEAN as much as of its predecessor, the Association of Southeast Asia (ASA). The decision-making bodies such as the Ministerial Meeting and the Standing Committee are in the nature of diplomatic gatherings, and in general the economic experts available in the planning or other economic departments of governments have seldom been drawn into the preparatory activities of the national ASEAN secretariats which are located in the respective ministries of external affairs. Compare this with the pattern adopted by the Regional Co-operation for Development (RCD)[5] in which, under the highest authority of the Ministerial Council, the Regional Planning Council composed of the heads of the respective planning agencies is charged with the planning and execution of co-operative schemes. The RCD Regional Planning Council is effectively assisted by a well-organized staff secretariat, including economic experts. In the case of ASEAN, the question of establishing a central secretariat could not be decided on by the Standing Committee and has been further referred to the member governments. It stands to reason that, while RCD can name a number of co-operative market-sharing projects to its credit, ASA and ASEAN have been rather slow in organizing such co-operative schemes as would directly affect the national structure of production

5 The member countries are Iran, Pakistan and Turkey.

and trade.

In these circumstances, the only approach to regional co-operation and integration that is politically feasible is probably to explore and consolidate possible areas of co-operation on a commodity-by-commodity or project-by-project basis. This partial approach has both its own advantages and disadvantages. The ground may be prepared for full-scale economic regionalism by starting with some decisions governing a limited field of economic activity. The extreme to which this approach may be carried is integration by sector, as exemplified by a commodity common market in the form of the European Coal and Steel Community. The potentiality of the sectoral approach is rooted in the logic of economic interdependence between individual sectors; in the case of commodity integration, the policy maker will sooner or later be confronted with the need for co-ordination of economic policy concerning the interrelated field of activity or for closer integration of the economies on a wider scale. If the integration movement is subject to such a self-reinforcing tendency, it may not greatly matter, indeed, at what point and in what field of economic activity it is initiated.

However, an economist who is trained to think primarily in terms of mutual interdependence among economic variables will be the first to see the narrow limitations to which such a partial approach is subject. Without a comprehensive view of the economic process, how can the purposes and directions of projects relating to individual commodities be defined and priorities among them be properly established? It is also obvious that the potential benefits of closer economic integration can only be identified within the framework of long-term perspectives, which necessarily encompasses the totality of national economic development. At present, the economies of the constituent countries of ASEAN lack complementarity, each of them exporting roughly the same commodities. Their trade is mainly directed to extra-regional sources and destinations; less than 21 per cent of the member countries' trade is intra-regional. If Singapore's entrepôt trade is excluded, the share of intra-regional trade falls to a mere 6 to 10 per cent. This is a factor which makes the probable immediate effects of trade liberalization in the ASEAN countries appear extremely limited.

In general, there are strong reasons for arguing that the free trade approach to regional integration, as applied in western Europe, will be less efficient in the developing regions. Within the framework of the European Economic Community, integration was to be realized through a progressive and automatic system of linear tariff reduction. If applied mechanically to the developing regions, the introduction of a free trade regime of this type would be fraught with difficulties. Firstly, in almost all countries, planning is recognized as the main instrument of development policy; and, where national plans are not geared deliberately to the requirements of the new situation, trade liberalization is bound to give rise to certain disturbances and disruptions in the national production and consumption programmes. Secondly, the market mechanism tends to favour investment in countries where the initial conditions are favourable and the profit prospects are bright; hence free trade might lead to undue concentration of investment in some specially favoured countries. Thirdly, the existing pattern of production and trade in the ECAFE region is not such that the mere lifting of trade barriers among the countries in the region would considerably increase the intra-regional trade flow. Fourthly, even assuming that mutual trade liberalization can expand the volume of intra-regional trade to some extent, in view of the prevailing supply rigidities it is rather doubtful whether this approach could have much impact on the economic growth of the developing countries. The primary task of economic policy will not be so much to expand commodity exchanges along traditional lines as to create a new complementary pattern of production which would open up improved prospects for accelerated growth.

These observations seem to have been confirmed to some extent by the experience of the Latin American Free Trade Association (LAFTA). Although in Latin America there was at the outset general agreement about the ultimate goal of regional integration, the method chosen, namely the establishment of a free trade area through gradual liberalization of traditional exports and imports on the basis of selective negotiation, did not ensure a speedy realization of the far-reaching targets of integration. No other method would have been acceptable to the developing countries, which inevitably encounter great difficulties in abandoning their restrictive trade practices; yet, this procedure evidently invoved the risk that each country would agree to free only those items in the production of which it had no interest. In the view of the ECLA secretariat, the experience in Latin America has shown that "the aims of economic integration cannot be achieved through the mere liberalization of trade, which must be accompanied by other agreements that constitute a real programme for the achievement of a series of major common objectives."[6] -- that is, by a regional investment policy.

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6 ECLA, "A Contribution to Economic Integration Policy in Latin America", (E/CN. 12/728), p.51

Such regional investment planning can be conceived of either as a necessary complement or as an alternative to the regional scheme of trade liberalization. As an alternative to the free trade approach, the plan harmonization approach seems to hold special appeal for the developing countries in Southeast Asia, particularly now that all of them have adopted national planning to guide the development process. Being defined as a partial or comprehensive extension of national planning to the regional plane, the plan harmonization approach will sooner or later lead to the formulation of an investment and production programme and policy from the point of view of the region as a whole. In the absence of a supra-national authority, however, it will aim at a deliberate co-ordination of national production efforts and investment policies and involve inter-governmental agreements on specialization and joint efforts preceded by an exchange of information, consultation and negotiations.

The effectiveness of the plan harmonization approach may be exemplified with reference to the principal requirements of agricultural and industrial planning in Southeast Asia. It is well known that, in the face of the declining price trend of the major export commodities, export-dependent plantation economies of the type of Malaysia are confronted with the need for agricultural diversification. But the regional study of FAO's Indicative World Plan comes to the conclusion that "given their restricted land resources and the limited possibilities of substituting annual crops for plantation, they may not be able to increase sufficiently internal production of other major crops and of livestock products to fulfil domestic demand".[7] Thus, despite the imminent agriculturel breakthrough in Asia, the prospects of self-sufficiency in food in some countries are not reassuring. On the other hand, some countries, including Thailand, might build up such a huge cereal surplus in the long run that "the problem of disposal could well prove insoluble",[8] If the economic projections, extending even to 1985, point to such an incongruity of supply and demand, there is obviously a case for harmonizing the food production and agricultural plans of the member countries of ASEAN right now; the inevitable loss in resource allocation involved in the excessive policy of self-sufficiency in food may be reduced to the minimum.

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7 FAO, "Main Conclusions and Policy Implications of the I.W.P. Regional Study for Asia" (FERC/68/3, 7 October 1968), pp.25-26.

8 FAO, "Main Conclusions and Policy Implications of the I.W.P. Regional Study for Asia" (FERC/68/3, 7 October 1968), p.23.

In the industrial field, reference is often made to the inefficiency of the forced import-substitution policy based on a narrow national market. We should avoid being dogmatic in this respect; for a respectable number of production processes, each of the ASEAN countries, except for Singapore, constitutes a sizable enough market to support efficient production.[9] This means that the legitimate scope for successful industrialization through import substitution should not be underrated even for relatively small and poor countries in Southeast Asia. But the list of light consumer goods industries to be established to replace imports will soon be exhausted in many relatively small countries. The weakness of the traditional industrialization strategy is rather reflected in the shallow vertical structure of the manufacturing sector in which the forward and backward linkage effects of individual sub-sectors are extremely limited. The industrial structure thus lacks the ability to generate self-sustaining growth impetus by inducing investment in interrelated sub-sectors directly or indirectly. The member countries of ASEAN can now be considered to have generally reached the turning point in the process of their industrialization at which the structure has to be deepened considerably in order to qualify industries to become "the leading sector" to self-generating growth.

The need is therefore for vertically integrated industrialization, but at this stage where a number of basic and intermediate industries have to be created, the national markets of many developing countries in Southeast Asia may prove too narrow. For instance, most countries of the area have started to establish an automobile industry in the form of assembly plants which mainly rely on imported materials and parts. In most cases there are too great a number of assemblers and types of vehicles produced to be economically justified. But, the most important drawback of this policy is that the possibility of integrating the industry backward is almost completely lacking, for integrated industrialization is not possible without some sort of supra-national market planning or harmonization of national investment and production programmes. It is therefore only logical that a co-operative plan for a steel industry in Singapore and Thai-

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9 "Outside of a few exceptional industries most technical economies are exhausted by firms of quite moderate size. Even relatively small and poor countries can have a number of firms of the minimum size to give full, or almost full, technical efficiency" E.A.G. Robinson, "Introduction", Economic Consequences of the Size of Nations, Proceedings of a Conference held by the International Economic Association, London 1960, xvii.

land seems now to be under active consideration.[10] Ensuring that full advantage is taken of the potential benefits of the broad regional market is of cardinal importance for the industrial development of the region, and agreed specialization is an effective means of reaping these benefits. Where modern technology dictates a minimum size of productive facilities far exceeding the limit of national markets, or where the investment requirements in certain lines of production surpass the financial capacity of a single country, some forms of joint project planning may be the solution.

Although the conditions for fruitful application of a scheme of automatic and complete trade liberalization are not present in Southeast Asia, less far-reaching measures of trade liberalization are practicable and would benefit the participating countries by increasing the intra-regional trade flow. To the extent that the actual trade volume is limited by some artificial barriers, tariff or non-tariff, it will be of great importance to try to eliminate these trade barriers. For instance, some degree of preference for imports from within the ASEAN area may be established by means of regional quotas for selected commodities.[11] The ASEAN countries may be willing to agree on some system of preferential tariff rates which may be attained by annual reductions on the agreed basis of the duties applicable to imports from within the region, while the tariffs applicable to imports from outside the region remain constant. Again, the scheme of a free list which was suggested by the ECAFE Expert Group on Trade Expansion in 1964 may deserve active attention as a possible subject of practical inter-governmental negotiations within the ASEAN area.

The advantage of trade liberalization on a limited scale is that a certain degree of regional outlook and discipline is imposed upon economic decisions with respect to new investments and national planning efforts. This is important because the continued neglect of regional possibilities tends to create vested interests which may hamper progress towards an integrated regional market at some stages in the future. The risk of creating vested interests may even arise in a wider developing region in which the formation of sub-regional groupings, such as ASEAN, is promoted as a stop

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10. Bangkok Post, 24 October 1968.

11. Thailand's Foreign Minister, Mr. Thanat Khoman is reported to have proposed such a soheme as "a first step towards a Southeast Aisan common market". See Bangkok Post, 5 December 1968.

towards wider regional integration. It is true that substantial commitments with regard to harmonization of investment and production programmes may be made more easily by a small number of countries in a sub-region than by a large number of countries comprising an entire region. If at the same time the sub-region or the constituent countries were to agree with other sub-regions or individual countries within the region to establish, for instance, a minimum degree of preference for imports from one another, or an upper limit to protective measures against one another, then the sub-regional markets would be embedded in a viable regional framework. The trade commitments at the regional level, though less far-reaching in nature, would effectively support the plan harmonization commitments at the sub-regional level and underscore the determination of the sub-regional groups to reap the benefits of trade liberalization in the geographically wider framework.

Insofar as payments restrictions prevent the full potential of intra-area trade from being realized in this region--and we know that payments restrictions are effective in the form of trade controls discriminating against intra-regional trade, there is no doubt that the establishment of some type of payments mechanism would be an important step forward towards the expansion of regional trade among the developing countries and thus towards regional integration. The main contribution of a payments arrangement in this regional context would not be so much to remove restrictions on currency convertibility, or to aim at a somewhat more smoothly functioning monetary system, as to facilitate the intensification of intra-regional trade on the basis of changes in the direction as well as the level of trade and production. As a matter of practical politics, the most promising basis for formation of such a constructive payments arrangements will be some sort of narrower sub-region with more intensive commitments for policy and plan harmonization. The ASEAN countries may agree with profit to follow the example of RCD which has already established a payments mechanism.

The operational approaches to economic regionalism can thus be made through various channels: agreed specialization and harmonization of investment and production programmes, trade liberalization on a selective and preferential basis, or some types of regional payments arrangement. Especially at the stage where the scope for successful import substitution on the basis of narrow national markets seems largely to have been exhausted, economic regionalism is a challenge to economic policy which Asian developing countries must face if they want to accelerate their pace of development.

III. Economic analysis in the service of policy making[12]

It has often been observed that there is today among the leaders of Southeast Asia a sense of urgency for regional economic co-operation as a principal means of promoting accelerated economic growth. Yet, those in authority appear rather reluctant to set out along an untrodden path and undertake anything beyond the limit of exchanges of information and purely tochnical co-operation. How can the reluctance to act be overcome, and the basis be laid for far-sighted action? What is required is, of course, political leadership. Such a leader is already born and will presumebly emerge at the right time among the new leaders of Southeast Asia. The first generation of leaders in post-war Asia were inescapably committed to emerging nationalism, and their achievements were inseparably bound up with the rise of nationalistic spirit. In contrast to them, the new leaders of the second generation have the great advantage of being able to look a little beyond nationalism and to act in accordance with broader ideals. But, let us also recall the decisive role that was played by Jean Monnet in the successful formation of the European Coal and Steel Community and the European Economic Community. Jean Monnet, personifying economic research and planning, prepared the blueprint for Europe's future and became thus the real architect of what was called the Schuman Plan. In Southeast Asia, too, it will be the task of economists and experts to lay a solid groundwork for regional economic integration. Such a blueprint is more than an instrument; it can forge courage and change deficient political will into determined policy. Southeast Asia is in urgent need of its own regional Monnet Plan.

The scope and elements of a strategy of regional co-operation and integration in Southeast Asia can only be defined through objective studies by experts of all the existing and potential possibilities of the region. Economic analysis will identify the likely consequences of various forms and levels of regional co-operation in some detail and will thus enable the policy makers in the relevant countries to form a more informed judgment regarding the desirable level of integration. The necessary institutional and administrative arrangements that should accompany a particular form of economic co-operation can then be worked out in greater detail to examine the practical feasibility of the co-operative programmes. It is hoped that economic studies will thus provide the basis for

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12. For many lines of arguments in this section, the author is greatly indebted to Dr. Amit Bhaduri, Delhi School of Economics.

facilitating policy decisions by indicating the probable consequences of alternative forms of regional cooperation. The purpose of the studies is not to arrive at a decision as to the particular form of co-operation to aim at. That, after all, is a question that cannot be settled on economic grounds alone.

Since the likely economic effects of integration depend crucially on the intensity level of co-operation achieved among the countries concerned, it will be necessary to start with several economic "models" or stylized pictures of regional integration as points of reference, in order to examine the possible implications of integration at various hypothetical levels. In the short run, the existing structure of production may be assumed as given; the only relevant instrument of action will be the commercial trade policies of the countries concerned. On this basis, it will be possible to examine the possible impacts of trade liberalization which can be carried out in varying degrees. For instance, assuming the logical extreme of free trade among the participating countries, it will be possible-- under certain restrictive assumptions-- to work out the quantitative order of magnitude of the gains from complete trade liberalization. Such exercises as have actually been undertaken in respect of European trade liberalization schemes have indicated that pure trade gains cannot be of great significance. Since there are good reasons for expecting that the gains from trade liberalization would be much less substantial in the underdeveloped countries than in the industrially advanced economies, it is to be anticipated that the short-term gains from trade liberalization will be but marginal in the countries of Southeast Asia. From the analytical point view, however, the short-term model of trade liberalization will serve to indicate what types of positive co-operative measures would be required to complement even the maximum degree of trade liberalization in order to accelerate the pace of regional development.

Complete trade liberalization may be a good theoretical point of departure for analyzing short-term commerical policy, but may not be the most relevant assumption to make. It is therefore necessary to modify the previous theoretical scheme of ascertaining the "gains from free trade" by assuming that the scope of trade liberalization is partial rather than complete. Clearly a large number of integration models with partially liberalized trade can be constructed, depending on the precise nature of trade agreements. In the present context, it appears more relevant to assume that trade liberalization is achieved only with respect to a clearly defined subset of tradable commodities, as illustrated by the proposal of the Foreign Minister of Thailand referred to above. Theoretically, this problem can be tackled quite easily in terms of a partial equilibrium framework, if we assume that the incremental volumes of trade in commodities included in the partial liberalization scheme do not affect the volume of other commodities being traded. This means that the problem of substitutabilities as well as complementarities among commodities, either in consumption or in production, is ignored. While this may be an assumption that is not compatible with the general equilibrium formulation of the problem, it may appear more useful to proceed on this assumption because its relaxation will confront us with difficult problems in terms of both data requirements and theoretical complications. Partial equilibrium analysis may rather be extended in a different direction with greater benefit; it will enable chains of dynamic effects over time to be analyzed within a limited area of production and trade, as exemplified by the tradition of Marshallian analysis.

While in the short run the impact of trade liberalization in the integrated area is the focus of attention, the emphasis shifts considerably in the long-term context. For, in the long run, the structure of regional production, far from being assumed as given, should be treated as a variable to be optimally adjusted to the requirements of integration, and instrument variables to be considered have to include not only commercial trade policy, but also investment and other changes in the use of production factors. The setting up of a long-term model of economic integration, therefore, presupposes the specification of two sets of economic conditions. First, the extent to which the structure of regional production can be manipulated is assumed as agreed upon by the countries concerned, and secondly, the exact nature of the trade liberalization policy adopted by the countries concerned is assumed to be known. There are also alternative ways of specifying the relationships between the two sets of policy instruments; either the decisions about trade liberalization are taken autonomously and the structure of production is optimally adjusted to the pattern of trade, or conversely, the trade policy is assumed to be dictated by the optimum pattern of intra-regional division of labour, as reflected in the structure of production of the countries concerned.

In the long run, too, it appears meaningful to distinguish two sets of economic integration models according to the varying scope and level of regional integration: the restricted or partial long-term integration model and the unrestricted long-term integration model. More specifically, the restricted or partial long-term integration model assumes (a) free movement of capital across national frontiers only on the basis of intra-regional agreements relating to specific projects, and (b) only partially liberalized trade in the sense of free trade in respect of some commodities, in particular those related to the project agreements mentioned under (a) above, but not all tradable commodities. The scope of economic integration is restricted as the model does not assume either complete trade liberalization or free movement of all factors; even in respect of capital, it does not assume free movement of capital for investment in all lines of production, but only in those industries where intergovernmental agreements can be reached on a project basis. In passing, it should be noted that in the light of the project-by-project approach which has generally been accepted so far by the governments in Southeast Asia as the only feasible method of regional co-operation, this restricted long-term integration model is endowed with a high degree of realism.

In contrast, the unrestricted long-term integration model is the logical extreme of regional economic co-operation. For this model, the underlying assumptions can be specified as (a) conditions of completely liberalized trade and (b) perfect mobility of all "factors of production", except those that are physically immobile (e.g. land). While this model cannot claim a great deal of relevance to the problems of reality, it should be able at least to serve as a frame of reference.

The analysis of the short-term effects of both trade liberalization and economic integration is usually based on the height of the original tariff rates, changes in these rates (in the form of reduction or complete abolition) and the responsiveness of the demand for and supply of traded commodities to price changes in the member countries. This, in turn, requires a study of the elasticities of import demand and export supply which will depend on the underlying elasticities of domestic demand and supply, the share of imports in domestic consumption, the share of exports in domestic production, the substitutability of domestic and foreign goods and the length of the period of adjustment. Indirect and feedback effects of integration are best examined in the framework of a model involving a set of simultaneous equations. What is important is the explicit articulation of the constraints depending on the nature and scope of integration. Econometric methods can be used with some benefit for an analysis of the short-term effects or of the long-term effects under very restrictive assumption.[13] If the participating countries

13. See, for instance, P.J.Verdoorn, "The intra-block trade of

formulate a set of well-defined and consistent objectives, then the effects of economic integration can be analysed in terms of a linear programming framework with linearized constraints.

The limitations involved in the nature and the reliability of existing data in Southeast Asia are overwhelming, indeed. However, even if reliable economic and technological data were available, there are several practical as well as theoretical reasons to feel somewhat sceptical about the usefulness of the programming exercise in guiding economic policy towards regional integration. The basic reason is related to the dynamic changes in the economies which are the most important elements in the potential benefits of integration. In order to identify the real scope for economic integration in Southeast Asia, it is necessary to examine alternative development strategies open to the countries concerned over time and to assess carefully the potential for structural change of the economies, especially for industrialization, on the basis of their resources, prospective demand structure and production and transportation costs. Such changes are not immediately visible along the lines of extrapolation of whatever trends exist today; they mean introduction of new structural elements. While some structural parameters may be somewhat modified on the basis of the agreed intentions for changes, such long-term structural changes cannot be derived from model analysis. This means that, if the programming exercise is to make any positive contribution to the solution of dynamic problems, it will have to be preceded by an independent discussion of development strategies on the basis of extensive techno-economic studies. The programming models developed so far, for instance, still find it difficult to deal mathematically with the question of increasing returns to scale, whereas in fact benefits from the scale effect are one of the important advantages which an integration model should examine.

In the programming approach, recommendations regarding a certain structure of intra-regional production will be derived on the basis of an optimal criterion or an "objective function". But it would appear extremely difficult for all the countries concerned to arrive at a common agreement on this point. The main problem which is faced here is the question of distribution of economic benefits among the co-operating countries. If the programming model

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(13. cont'd) Benelux" in Economic Consequences of the Size of Nations. Proceedings of a Conference held by the International Economic Association. Edited by E.A.G. Robinson, London 1960.

analysis is guided exclusively by an efficiency criterion, the "agglomeration factor" would tend to concentrate investment in the form of industrial complexes in most favourable locations. This may ensure the optimum allocation of resources over the area, but may make the pattern of distribution of industrial activities among the countries less equitable. A sort of "compensation principle" can be incorporated in the model that no country should be worse off in terms of income after the integration agreement than before, but it is not at all clear that this will be a sufficient condition for equitable distribution of benefits for the countries concerned.

What the policy makers need as a guideline to strategic decisions regarding the problem of regional integration is probably not a picture of the final goal representing the ideal structure of intra-regional production and trade alone. They want to know also the path which leads to that goal. In this respect, the programming models do not do full justice to the demand, because such models involving total or Utopian planning do not allow us to formulate a piecemeal approach. It cannot be said, for example, that we shall satisfy marginal conditions in some industries, but not in others, as that statement will be logically invalid due to the "second-best" type of arguments in economic theory. However, a real problem awaiting solution in concrete terms is posed to the economists by a piecemeal approach on a project-by-project or commodity-by-commodity basis which has been endorsed by the governments of Southeast Asia.

Models of economic integration, in the long-term context, are particularly useful in providing a necessary frame of reference for any meaningful projections over time. But, if all the considerations relevant to dynamic integration policy are to be taken seriously, this would mean that a great deal of techno-economic research should be undertaken first outside the models. The more pedestrian approach to the questions such as choice of locations, effects of scale and agglomeration and distribution of benefits from integration may require, in fact, a higher degree of economic expertise than the setting up of formal programming models. It can be hoped that important building blocks for the workable strategy of regional integration will be assembled this way. This is not to say, however, that the analytical importance of models should be minimized; if sufficiently equipped with these building blocks, a formal programming model will be transformed into an effective decision-making model with realistic contents.

COMMENT ON HIROSHI KITAMURA'S PAPER BY ROBERT TRIFFIN

I would like, first of all, to express our common debt to Dr. Kitamura for his lucid and forceful summary of the basic rationale of economic regionalism. Academic economists persisted much too long in damning regional organization as an inferior alternative to worldwide organization. I view it myself, on the contrary, not only as a step toward this broader objective, but as part and parcel of a "structured" world organization, relieving worldwide institutions such as the IMF, of whatever tasks can be solved just as efficiently, and often more efficiently indeed among a smaller number of countries, better prepared to understand and trust each other.

There is much that I would like to add, but time is short. Let me merely mention that the death of "laissez faire" as epitome of national domestic policies could not leave unaffected the external "laissez passer policy which was its logical complement. As pointed out by Dr. Kitamura, progress toward trade liberalization, in an age of economic interventionism, requires for its success coopera tion and commitments extending far beyond the field of trade policy proper, and extremely difficult to negotiate among more than a hundred independent sovereign countries (no matter how theoretical and illusory the sovereignty is in practice).

The broad arguments are reinforced, in most underdeveloped areas, by the fact that the present trade pattern--and particularly the low level of intraregional trade often mentioned as an argument against integration--is by no means a reflection of the natural pattern of endowment of resources, but has been deeply distorted by historical accidents, such as:

An economic infrastructure inherited from colonial days, and tending to promote trade with the "mother country" rather than with neighboring countries:

The erection of non-discriminating tariff walls protecting the "infant industries" of each country against the infant industries of its neighbors as well as against the adult industries of the more advanced countries. Insofar as imports could still be able to jump over the barriers, this type of protection, while theoretically non-discriminatory, discriminated against de facto in favor of the adult industries of the developed countries, and against the infant industries of neighboring, underdeveloped countries.

Regional preferences need not then uniformly lead to an uneconomic distortion of "natural" production and trade patterns. They may, indeed, be necessary to help correct the distortion inherited from those historical developments.

I agree therefore, with Dr. Kitamura's general approach, and particularly with the broadening of the objective of regional economic cooperation beyond the mere removal of the trade barriers. In a world of national economic interventionism and planning, the objective of regional cooperation, must be, as he suggests, to improve planning through more sophisticated research, through the enlargement of inappropriately narrow economic areas, through the harmonization of national plans aiming at making them compatible and mutually supporting rather than incompatible and mutually defeating.

I agree with all this, even though I might be somewhat less optimistic as to the ease and wisdom with which this may be achieved and implemented in practice. The market itself may help solve some of the national susceptibilities that are often an obstacle in this respect. Anonymous market disciplines may be accepted more easily than the decisions of a supranational or even international planning board.

My main qualm, however, is not about this broadening of the objectives of regional economic cooperation, but about its narrowing down to "import substitution" as one of major objectives to be pursued. Surely, this is a counsel of despair, and I would put instead the main emphasis on "outward-looking" integration, all the more so if and when such integration may have to be confined initially--as suggested by Dr. Kitamura--to sub-regional, rather than regional, groupings.

I applaud, for this point-of-view, Dr. Kitamura's remarks on the general equilibrium approach and the dynamic, as well as the static, aspects of regional liberalization. Let us not forget that such liberalization will necessarily be trade-creating insofar as previous protection was effective, i.e. promoted artificially uneconomic national production in substitution of imports. Such trade creation should lower production costs and improve the overall competitiveness of members, not only within the region, but outside the region itself. This explains, to my mind, why intra-OEEC liberalization, for instance, could soon be followed by liberalization of trade toward non-members.

Secondly, regional liberalization may, of course, on the contrary, be trade-diverting insofar as protection was ineffective--as it always is to a large extent--and did not stop imports from the outside.

But, again, the dynamics of such trade-diversion may bring some partial corrections to it. Insofar as the members of the region now import from each other goods which they used to import from outside the area, their balance-of-payments should improve for the area as a whole and enable them to increase imports from outside the region, to lower their levels of restriction. Indeed, they may be induced to do so by the fact that they do not wish to build up indefinitely their foreign exchange reserves, i.e. to grant low-earning credits to non-members.

Finally, I would definitely differ with Dr. Kitamura in his suggestion that regional payments mechanisms should be directed at a systematic modification of trade and production patterns. What he has in mind, if I am not mistaken, is that memebrs in surplus within the region should be forced to finance members in deficit within the region. In practice, this might force poorer countries, with overall balance-of-payments deficits, to finance richer countries with overall balance-of-payments surpluses, simply because the first may be in surplus within the region, and the latter in deficit within the region. This would obviously be absurd. A country should not be penalized because it happen to be able to produce efficiently and economically export goods needed by neighbors which can themselves produce efficiently goods having a normal outlet outside the region rather than within the region.

I have dwelt too much on the differences in emphasis, but wish to stress, in conclusion, that they do not detract from the basic similarity of our approaches and our support for regional integration. In brief, regional integration should itself be integrated with broader, worldwide, but decentralized, techniques of policy harmonization in an interdependent world.

COMMENT ON HIROSHI KITAMURA'S PAPER BY P. D. DRYSDALE

Like Professor Triffin, I believe that Dr. Kitamura has presented us with an extremely thoughtful paper which sets the evolution of the regional approach to economic development problem in the Asian region in what seems to be its proper perspective.

He stresses the technological necessity of the regional approach to industrial development among relatively small less developed countries if their manufacturing sectors are to be reasonably efficient. There is some ambivalence in his judgment about this matter, however, but I think that it derives principally from his recognition of the distinction between the technological necessities for the efficient development of labour-intensive light manufacturing industries and those for the efficient development of capital-intensive heavy manufacturing industries. There is a related question--which Professor Triffin has already raised--of Dr. Kitamura's focus on the process of import substitution rather than efficient, and hopefully, export-oriented manufacturing development as the rationale for economic regionalism. Of course, competitive export industries, at some earlier stage, are frequently import-competing industries. But it is perhaps a real error to put too much stress upon the process of import sunstitution: that only results in confusion in the choice of priorities for manufacturing development. Australia and New Zealand provide evidence enough of that.

Dr. Kitamura traced the limited progress towards economic regionalism in South East Asia through ASEAN. He is not discouraged by the lack of concrete achievement. On the contrary, he stresses the importance of what I call the <u>corroboree approach</u> towards effective economic co-operation. A corroboree is a ritual practiced by Australian aboriginals. Elders gather together, generally make a lot of noise and have a jolly good time, but the basic movement involves going round and round in circles. I welcome Dr. Kitamura's tolerance of this kind of activity. It is a precondition to effective economic co-operation; the preliminary identification of common interests is as important a part of the business of regionalism as their realisation.

Realistically, Dr. Kitamura draws attention to the barriers to comprehensive regionalism in South East Asia. But he is optimistic about the possibilities of limited, or sectoral, economic co-operation within the area, and he rightly stresses the need for more fact-gathering.

With what Dr. Kitamura has written then, I am largely in agreement. There is, however, an interesting and important omission from his paper. There do the developed countries, for example, of the ECAFE region itself, fit into his kind of regionalism? I assume that they should be excluded from direct participation in the kind of arrangement he has in mind since their participation would offend the principle of equality which nowadays has general acceptance.

Some discussion of the desirable relationship between the trade and economic policies of the advanced countries among themselves and towards developing countries within ECAFE would be useful. If Dr. Kitamura accepts the principle of non-reciprocity in trade and economic policies between advanced and developing countries, for example, would he agree that advanced countries are likely to be able to provide more in the way of trade concessions for developing countries if they combine the negotiation of reciprocated concessions, however limited, amongst themselves with the extension of trade preferences and economic assistance? I have been arguing in the course of our discussion that they would. Althernative views have been expressed. Dr. Kitamura himself questioned the wisdom of a two-directional approach yesterday. He wanted to know who came first within OPTAD--the advanced Pacific countries or the Asian developing countries? It seems clear to me that they should all come together, but it seems equally clear that the nature of the relationship among the former, and between the former and the latter, even within OPTAD, must be quite different. Earlier, Professor Lockwood questioned the two-directional approach because he felt that the extra squeeze on advanced country industries hurt by trade concessions in both directions would make the whole operation so much the more difficult. Professors Castle and Kojima made directly contra-assertions: whilst some adjustments are being made it appeared to them easier to engineer more. Professor Johnson came down on the side of Castle and Kojima, but for a rather different reason: the administrative and political effort of organizing the trade negotiations involved would, he has argued, be minimumized by a single two-directional operation. It seems to me that there is a much more important consideration in all this. The fact of political life is that trade concessions are easier for governments to make if there is some element of reciprocity, for the simple reason that the political groups who benefit from concessions gained can be played off against those which lose from concessions made. Thus, if reciprocated concessions among advanced countries--and they may be well short of a complete free trade area—are coupled with non-reciprocated preferences for developing countries, the latter are more likely to be taken a whole lot further.

Moreover, there is the added advantage of the regional approach to preference-giving which this implies. The regional approach involves a kind of burden-sharing and moral pressure which are also likely to be helpful.

I would very much like to hear what Dr. Kitamura feels about these questions which arise out of his paper.

DISCUSSION OF PAPERS PRESENTED BY K. LIANG, SUBROTO AND H. KITAMURA

In reply to comments on his paper, Professor Liang said he thought that aid-generated local currency funds contributed substantially to financing private investment and government expenditure at a time when Taiwan did not have any well-organized monetary and capital markets. He also said that now that direct aid had ceased and there was greater reliance on borrowings from international financial institutions, there should be more consciousness of productivity criteria and comparative advantage criteria in the choice of investment projects.

In reply to comments on his paper, Professor Subroto made two additional points about the progress made under Indonesia's stabilization programme. First, he admitted that a good season had been partly responsible for increased rice production in 1968. However, the increased application of fertilizer and superior seed strains had also made their contribution. Second, he said that there had been problems with the timing of aid inflow in 1968. Indonesia is receiving aid from all the advanced Pacific countries, with New Zealand as an observer, as well as European nations. These countries met to assess needs and after about three months there was a second meeting to settle the amount of aid to be extended. In consequence, there was a long gestation period, of about six months, during which time, Indonesia had to finance import requirements from external accounts. There is then some need for bridging the gap. Professor Subroto agreed that the basic problems in the fields of employment, production, and the effeiciency of the administrative apparatus were tremendous and that they would only be overcome slowly.

In reply to comments on his paper, Dr. Kitamura said that whilst it was true that if the intra-regional balance of payments criterion for credit provision was adopted, the poorer members might be forced to lend to the richer members, the whole object of the exercise in economic regionalism was to correct the biases in trade and production structure which caused these perverse effects. That is why agreed specialisation and industrial harmonization, which encouraged adjustment in the structure of regional trade and production, would be helpful in the establishment of a successful union. He agreed that the advanced countries had an important role to play in regional development. He believed that the ideal approach would be similar to that taken by Mexico towards Central American integration. Mexico looked sympathetically upon attempts at regional integration, and gave non-reciprocated tariff concessions. Dr. Kitamura also argued that if the advanced countries were not directly involved in integration among developing countries there would be less fear of dominance of developing country markets by multinational corporations.

In discussion of the Taiwanese and Korean cases, questions were raised about the role of land reform and taxation reform in economic development. Professor Liang said that he believed that land reform had been remarkably successful in stimulating agricultural productivity through improved farmer incentives. Agricultural development had provided the base for subsequent industrial development. Professor Chough indicated that taxation reform rather than land reform had made the greatest contribution to agricultural development in Korea. He added that efforts towards the improvement of agricultural technology were also significant in raising agricultural productivity. The Korean Institute of Science and Technology had played an important role in this respect.

Finally, both Professors Liang and Chough agreed that it was difficult to foresee what the exact effect of the conclusion of the Vietnam War would be on their countries' trade. They both stressed the crucial role of trade with Japan and the United States and the need for freer access to these markets, so that specialization in labour intensive exports might be further strengthened.

Discussion of the Indonesian case led one participant to observe that although there had been a dramatic slowdown in the rate of inflation, from 626 percent to about 30 or 40 percent per annum, there was still a long way to go. The financial mechanism was unlikely to work effeciently where inflation remained so high. Pro fessor Subroto agreed that the rate of inflation would have to be checked further. Of course, there was always the danger that disruption to food supply, textile supply, or foreign exchange flows, would frustrate the objective of price stabilisation.

Another participant asked where the major opportunities for growth and development lay, in view of the rather depressing view that emerged from earlier commentaries. Professor Subroto explained that the greatest potential was undoubtedly to be found in the extractive industries such as oil, nickel, copper, and forest products. There was also a very great need for replacement investment in agricultural industries, such as rubber and foodstuffs, which had been allowed to run down in the past decade and a half. He estimated that development projects of this kind would require about $US 6.0-7.5 millions in foreign exchange. The amount of private capital attracted to Indonesia in the past two years amounted to about $US 3.0 millions.

Others still were concerned about the 3 percent rate of population growth. There will be a population explosion in the middle 'seventies and Professor Subroto said that emphasis was being given to development centers in less densely populated regions. He said there were no important religious objections to family planning but lack of knowledge and education was a major obstacle.

In discussion of the need for Asian economic regionalism, questions were raised about whether Dr. Kitamura's stress on the need for vertical integration was consistent with Professor Kojima's concept of agreed specialisation. Dr. Kitamura thought that it was first important for developing countries to press forward with dynamic industrialization and later to proceed toward horizontal specialization of the kind Professor Kojima had in mind. He suggested that import substitution was an important prior stage to effective export specialization. Others felt strongly that the emphasis on import substitution and vertical integration was likely to lead to wrong priorities in development policy.

Chapter 14

ECONOMIC COOPERATION WITHIN THE ASIA-PACIFIC REGION: A SUMMARY VIEW

William W. LOCKWOOD

Three days of lively discussion among scholars from ten nations at this Second Conference on Pacific Trade and Development are not easily compressed into a brief summary. To simplify matters, I have confined myself to broad issues and findings of fact, leaving aside matters of research methodology and technical detail, however valuable to the specialist. Also omitted are personal attributions. Much of the color and controversy of the dialogue thus tends to disappear. What remains may serve, nevertheless, to integrate the separate papers within the inclusive analytical structure of the Conference agenda. At least the general tendencies of the discussion stand out, especially areas of broad agreement.

The Conference topic was set forth as "Trade and Aid Relationships of the Developing Countries of Asia with the Advanced Countries of the Pacific." Its distinctive value was the emphasis upon interplay, actual and potential, between international trade and aid policies, as related to economic development. This was highly rewarding.

Its second organizing principle was its focus upon the Asia-Pacific region. Useful as this was, it gave us constant trouble. For many issues can only be tackled within a wider, global framework. No consistent, exclusive relationship exists between the interests and commitments of the advanced nations of the Pacific in this region, and the interests and commitments here of the developing nations of Asia. For example, India has received substantial aid from Europe, e.g., $570 million from 1961 to 1966. And, on the other hand, the United States and Canada are certainly not less interested in the trade and development of Latin America than of Asia. These complications are inherent in any regional approach to international economic policies in the Pacific, of course, except as a transitional step towards wider, global solutions that are presently blocked for one reason or another.

The Conference began with the general setting of world economic policies as set forth in papers by Harry G. Johnson, Sperry

Lea, and H. Edward English. It then narrowed its focus to regional tendencies and proposals, specifically the idea of a Pacific Free Trade Association among the five advanced countries (Japan, Australia, New Zealand, Canada and the U.S.), and its implications for Asian trade and aid. (See papers by Bruce W. Wilkinson, L. V. Castle, and Kiyoshi Kojima-I. Yamazawa). Next it narrowed its discussion still further to the proposal for a Japan-Australia-New Zealand Free Trade Association, explored in papers by I. A. McDougall, Peter Drysdale and L. V. Castle. These discussions consumed the first day, retracing some of the ground covered in the 1967 Tokyo Conference on Pacific Trade and Development.

With this beginning, the Conference turned more directly to the developing nations of Asia. It explored their needs and potentials for structural adjustment with the Pacific advanced nations through trade and aid, as analyzed in several of the foregoing papers, especially the Kojima-Yamazawa study. This led into Asia's intra-regional needs and problems, especially those of the ECAFE region and Southeast Asia. (See paper by Hiroshi Kitamura). Here considerable attention was paid to the promising new Asian Development Bank (ADB), as assessed by Masaru Fukuda, and to proposals for regional monetary cooperation developed by Robert Triffin.

Finally, the discussion centered upon three concrete national experiences in aid, trade and development over the past decade: Taiwan and Korea (Kuo-shu Liang), and Indonesia (Subroto). Given more time, we might logically now have reversed our course, applying specific country experiences to test earlier propositions regarding the region as a whole, then linking them back in turn to the higher wisdom of global strategy. It is precisely this kind of movement back and forth between broad conceptualizations and particular case studies that is best calculated to yield sound judgments of institutional design and policy.

Next Steps in Trade Policy: Universalism or Regionalism

One basic principle of trade strategy commanded agreement at the outset. The ultimate goal for the world must remain that of a global system of multilateral freer trade. This should be a system open to all, and non-discriminatory except as generalized one-way preferences might be built into it temporarily to enable developing nations to win new export markets in the developed countries and thus more rapidly narrow the North-South gap.

Progress toward this global goal seems arrested for the present. But this need not be cause for discouragement. The Kennedy Round reductions are a great achievement, leaving non-tariff barriers as the chief remaining obstacle to be overcome. When one recalls the era 1929-49, and compares it with 1949-69, it is clear that we have come a long way.

In the matter of generalized preferences for developing countries, the United Nations Conference on Trade and Development has been a grievous disappointment to its sponsors. Just as aid levels are falling, indeed, the prospect for trade preferences now seems even less promising, at least on a global basis. Meanwhile, with the movement towards multilateral free trade among the developed nations also on dead center, the United States in 1968-69 is the scene of a protectionist resurgence that may erode somewhat -- though probably not greatly -- the gains of the Kennedy Round.

Under these circumstances, the next step forward can best be made perhaps through various regional free-trade agreements modelling on (or perhaps enlarging) the European Economic Community (EEC).

Here the discussion turned to the concept of a Pacific Area Free Trade Association (PAFTA) embracing Japan, Australia, New Zealand, Canada and the United States. The appraisal of PAFTA at the 1967 Tokyo Conference on Pacific Trade and Development was continued at Honolulu, with fresh, workmanlike assessments of its possible effects in trade creation and trade diversion among these five advanced nations.

For the present, clearly, PAFTA can hardly be regarded as a feasible alternative. The U.S. still clings to the hope of further non-discriminatory reduction of trade barriers. And it attaches to Latin America and Europe an importance in trade certainly no less than to the Asia-Pacific region. Especially is this so when PAFTA would appear to imply a weakening of the U.S. trade balance, and, if extended to agriculture, to injure important sectors of American farming. Similar reservations on PAFTA prevail in Australia, Canada and New Zealand with their industrial protection, and in Japan with her sheltered agriculture.

At best, then, PAFTA remains a matter for the future, and only then perhaps if Europe turns increasingly inward. Should it ever be attempted, its terms of membership should be open-ended, making it a possible step towards a wider, eventually universal free trade association.

If not PAFTA, then, what about a more modest free trade arrangement embracing Japan, Australia and New Zealand (JANFTA)? Here economic complementarity is already high, and growing. In papers and discussions the Conference probed into the implications of JANFTA for these three countries in terms of trade balance, income, and employment, and also its implications for the developing nations of Asia.

Again the realization of JANFTA seems blocked presently by Japan's import barriers on farm products, by industrial protection in Australia and New Zealand, and by reluctance to risk either discrimination against the U.S. on the one hand, or the sacrifice of Commonwealth preference on the other. Some sectoral integration may be possible even so. For example, it might prove mutually advantageous in specific industries such as autos, steel and aluminum, either on a preferential or a most-favored nation basis. Along with this could come also an expansion of triangular trade relations with countries of Asia.

Clearly all such proposals require more study, more educational effort, and trial negotiations. What seems to be needed is a Japan-Australia-New Zealand Office of Trade and Development, or preferably an Office of Pacific Trade and Development (OPTAD). A "Pacific OECD" could enlist the joint efforts of governments, business, academic and scientific agencies to explore next steps -- steps in trade, in aid, in the regulation of investment practices, shipping, and airlines, and in all the networks of contact that now crisscross the Pacific.

While agreeing that an OPTAD would be a valuable, if modest, undertaking, the Conference was divided and uncertain over its precise terms of membership. Should it be confined to the five advanced Pacific nations? Or should it be open to any and all in the entire region? The answer depends on its precise functions, still to be worked out. Certainly its membership and functions should not be so broad as to duplicate or interfere with the ECAFE, the OECD, the ADB, or other such agencies already on the scene. Nor, on the other hand, should it be so restricted as to appear in Asian eyes to be merely an imperialist entente among affluent aid-donor nations of the Pacific.

Trade and Aid: Asia's Needs and Policies

Asia and PAFTA. The countries of developing Asia, broadly speaking, face a sharp dilemma today. On the one hand is their continuing need for more effective cooperation from the advanced nations in support of their development. On the other are the poor prospects immediately ahead -- prospects either for greater trading opportunities in the West, or for foreign aid sustained at even the level of the mid-60's. All assessments of the ECAFE region as a whole emphasize the importance of new export markets to relieve the foreign exchange constraint on growth as the long-term road to development. In the short-term, however, any rapid expansion of export capabilities, whether in food, raw materials, or light manufactures, will require substantial financial and technical assistance from outside.

A grand design for just such structural adjustments in markets, especially with the advanced nations of the Pacific, is outlined in Kiyoshi Kojima's paper "Asian Developing Countries and PAFTA." It calls for the allocation of large sums of capital by the advanced nations to build up rapidly the export capabilities of Asia in both industry and agriculture. Other subsidies and regulatory adjustments would be needed to handle dislocations in the advanced economies that would follow from the withdrawal of protection to high-cost, labor-intensive trades and their displacement by imports from Asia. Large commitments would equally be necessary in the field of education and technical assistance in Asia, in order to provide the needed skills, both technological and managerial. The political and administrative burdens imposed on governments in all participating countries would likewise be formidable, to say the least.

Spread out more slowly over time, the requirements of the Kojima proposal become more manageable. In fact, much progress is already underway in Asia in fields like new crop technology, family planning, education, and new industries and mining ventures oriented to overseas markets. Windfall gains from U.S. spending on the Vietnam war has lately provided a stimulus in neighboring countries. In the future new potentials for foreign aid, at least in Southeast Asia (e.g., the Mekong Valley), may appear if the end of the war brings a fresh resurgence of political will among donor nations. If so, this may also bring with it fresh incentives and pressures towards regional cooperation among Asian developing countries.

Regionalism Within Asia. What, then, is the promise of intra-regional cooperation in Asia, especially among countries that alone are too small to enjoy potential economies of scale? As a transitional stage, at least, between a narrow nationalism and some wider grouping, does Asian regionalism offer hopeful prospects?

The answer lies very much in the realm of political leadership. Recent developments suggest that the Association of Southeast Asian Nations (ASEAN), with a population of 200 million and a GNP of $25 billion, may conceivably move towards constructive forms of regional cooperation. If so, this must go well beyond trade liberalization, for intra-regional trade among Southeast Asian nations is hardly 10-15% of their total trade. Along with some freeing of intra-regional trade, perhaps through selective preferences, the prime need is for joint investment programs regionally planned. These would harmonize and integrate national development plans, with import substitution leading on progressively to export development on a regional basis.

Beyond consultation, and some technical cooperation, supported by foreign aid programs and by the Asian Development Bank, all this still lies mainly in the future. Thus far it remains in the realm of rhetoric more than reality. However, it is well to remember that the EEC was likewise many years in gestation.

Monetary Cooperation. Meanwhile two major institutional developments may give a big boost to regional cooperation -- one under active consideration and the other already a reality.

A Conference paper by Robert Triffin reviews his well known proposal of 1967. It calls for a negotiated credit reserve standard for the ECAFE region, to replace the gold and foreign exchange reserve system. The latter, he argues, is less and less adequate to meet the world's needs, or even to prevent recurrent financial crises of increasing frequency. By contrast, an Asia-Pacific credit-reserve system, pooling reserves regionally and investing them partly within the region, would be more economical, and offer greater assurances of liquidity, convertability, and protection against default.

Details of the proposed monetary reform are open to debate, of course. Concerning relative costs and benefits there is some disagreement. But ECAFE thinking appears to be moving at least towards a regional clearing arrangement, with some pooling of reserves. Such a reform, say its sponsors, would foster trade liberalization and economic stability. It is mostly the creditor nations that are still unpersuaded as to its security and feasibility. Another five years may well bring some such scheme to fruition.

Asian Development Bank. Already in operation is one major new instrumentality for regional development -- the ADB. While it enjoys the backing of the developed nations, of the West, it is importantly Asian in inspiration and management.

The Bank's functions and modes of operation are still in the early stages of development. It is a bank; but it is also a development agency. In the latter sphere it not only invests its own funds; it also provides technical assistance (e.g., in agriculture, highways, water resources), and serves as a trustee for special funds contributed by donor members.

Many issues concerning the ADB remain to be worked out e.g., its distinction from the International Bank for Reconstruction and Development (IBRD), its terms of concessionary financing (soft loans), and the balance of power among various groups within its Board, especially between donor and borrower nations. Basic to its whole conception is the fact that while its funds come mainly from affluent nations -- Japan and the West -- it was founded to assist developing Asia, and South Asia no less than East or Pacific Asia. Thus it is neither just a lenders' club, nor a borrowers' club, nor a Pacific bank, nor even completely an Asian bank in its operations and its controls.

Aid, Trade and Development: Taiwan, South Korea, Indonesia

Moving first from global to regional issues, and then from the Pacific to the Asian region, the Conference came finally to three specific cases of national development in Asia -- each different from the others, but all of absorbing interest.

Taiwan and South Korea. These two East Asian nations are fast becoming showcases of Asian development. The reasons are to be sought in the capacities of their people, their heritage of colonial development under Japanese rule, their security today behind the shield of American military protection, and large inputs of foreign aid and investment.

High-pitched growth set in later in South Korea than Taiwan because of bitter civil war and consequent political instability. Since the early 60's however, both have displayed similar characteristics -- growth rates of 6-9% over some years, rising savings and educational levels, and exports advancing rapidly in scale and in diversification of products and markets.

Korea and Taiwan point to the need for accelerated adaptation of new technologies, especially with the phasing out of foreign aid as in Taiwan. Likewise they pose the question how long and on what scale must aid continue in order to achieve big pay-offs. A critical variable here, of course, is the will and capacity of nation-building leadership, both government and business to evolve viable, dynamic forms of public and private enterprise in close cooperation.

Meanwhile Indonesia offers a testing ground for aid and trade of a quite different order, and at an earlier stage of development. With new leaders in power, after a decade of economic disorder and disintegration, Indonesia is now passing through the first phases of rehabilitation, aided by a 10-nation grouping of aid donor working with the IBRD, the IMF, the ADB and other international agencies.

The worst ravages of inflation in Indonesia had been repaired by the end of 1968. More positive measures of stabilization -- internal and external -- are now going forward, preparatory to fresh programs of development. The new forms of multilateral aid cooperation being evolved in Indonesia, with Japan and the U.S. each furnishing one third of the total aid budget in 1968, may set a precedent with wider implications for other nations of Asia in the future. The precedent is significant not only because of its economic efficiency but also because its multi-national character assures the Indonesians that it is largely a-political in nature.

CONCLUSION

The Conference, it will be seen, ran the full gamut from global generalities of high policy to the concrete minutiae of recent experience in three Asian nations. In this regard it faithfully reflected the real world of the development economist as theorist and practitioner. Concepts of modernization at a high level of obstraction are of little practical value except as they help one reach policy judgments in particular situations. In both respects, the Honolulu Conference was fortunate in having a dozen papers of uniformly high caliber. Altogether, the fund of knowledge and experience assembled here in scholars from ten countries around the

Pacific is itself striking evidence of a growing Pacific community, sharing increasingly a consensus on the kind of world it wants and the requisites for progress in that direction.

It remains only to close with a reminder, nonetheless, that the Asia-Pacific region in its totality embraces nations not only rich and poor, not only North and South, but also East and West -- split apart by a deep ideological gap and political antagonism. The Soviet Union is an advanced country of the Pacific, a donor of aid in the 50's, and now a Eurasian nation seeking capital and technical enterprise from Japan to develop its Eastern regions. And dominating the map of East Asia is another great nation -- the 700 million people of China. The second great Communist power of the Asia-Pacific region, China is also the nation with one of the most disappointing records of development in the whole area over the past decade.

Sooner or later, Communist and non-Communist Asia must be somehow brought within one orbit of peaceful negotiation and exchange. Otherwise this cleavage through the heart of the Asia-Pacific region will threaten us all with catastrophe.

SCHEDULE OF THE CONFERENCE

THURSDAY, January 9, 1969

Session I Future World Trade Policy

Chairman: Wytze Gorter

"THE NORTH-SOUTH PROBLEM IN THE WORLD ECONOMY AND THE IMPLICATIONS OF UNCTAD 1968"

Reporter : Harry G. Johnson
Discussants: Hiroshi Kitamura and L. V. Castle

"THE FUTURE SHAPE OF U.S. TRADE POLICY: MULTILATERAL OR FREE TRADE APPROACHES?

Reporter : Sperry Lea
Discussants: B. W. Wilkinson and Kuo-shu Liang

Session II Trade Cooperation Among the Advanced Pacific Countries in Relationship with Neighbouring Regions

Chairman: Malcolm MacNaughton

"A RE-ESTIMATION OF THE EFFECTS OF THE FORMATION OF PACIFIC AREA FREE TRADE AGREEMENT"

Reporter : B. W. Wilkinson
Discussants: I. A. McDougall and H. G. Johnson

"ALTERNATIVE POLICIES IN TRADE COOPERATION OF THE ADVANCED PACIFIC COUNTRIES IN THE NEXT FIVE YEARS"

Reporter : L. V. Castle
Discussants: Soon Chough and Sperry Lea

Chairman: Jose Encarnacion

"JAPAN, AUSTRALIA, NEW ZEALAND: THE PROSPECT FOR WESTERN PACIFIC ECONOMIC INTEGRATION"

Reporter : Peter Drysdale

SCHEDULE

"JANFTA AND ASIAN DEVELOPING COUNTRIES: SECTORAL ANALYSIS"

Reporter : I. A. McDougall
Discussants: Hisao Kanamori and H. W. Arndt

FRIDAY, January 10, 1969

Session II (Continued)

Chairman: H. W. Arndt

"ASIAN DEVELOPING COUNTRIES AND PAFTA: DEVELOPMENT, AID AND TRADE PREFERENCES"

Reporters : Kiyoshi Kojima and I. Yamazawa
Discussants: Subroto and William Lockwood

Session III Cooperation with Respect to Money and Capital Movements

Chairman: Hung Wo Ching

"INTERNATIONAL MONETARY COOPERATION IN ASIA AND THE FAR EAST"

Reporter : Robert Triffin
Discussants: Harry G. Johnson and Arthur Paul

"THE ROLE OF ASIAN DEVELOPMENT BANK IN ECONOMIC DEVELOPMENT IN ASIA"

Reporter : Masaru Fukuda
Discussants: Jose Encarnacion and Hugh T. Patrick

Session IV Evaluation of Aid and Trade Policies of the Pacific Advanced Countries Towards Asian Developing countries

Chairman: Boyd MacNaughton

"AID, TRADE AND ECONOMIC DEVELOPMENT: EXPERIENCE OF TAIWAN AND KOREA"

SCHEDULE

Reporter : Kuo-shu Liang
Discussants: Soon Chough and Arthur Paul

SATURDAY, January 11, 1969

Chairman: Shelley Mark

"AID, TRADE AND ECONOMIC DEVELOPMENT: EXPERIENCE OF INDONESIA"

Reporter : Subroto
Discussants: H. W. Arndt and Masaru Fukuda

"ECONOMIC DEVELOPMENT AND REGIONAL COOPERATION IN SOUTHEAST ASIA"

Reporter : Hiroshi Kitamura
Discussants: Robert Triffin and Peter Drysdale

Session V

Chairman: Hugh T. Patrick and Kiyoshi Kojima

Summary of Discussion: Sessions I - IV
William Lockwood

Free Discussion.

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